Report on the
Privatization Options for the
Workers Compensation Fund

June 16, 2003

Deloitte & Touche

June 16, 2003

Governor Michael O. Leavitt
State of Utah
210 State Capitol
Salt Lake City, Utah 84114

Dear Governor:

This is Deloitte & Touche's final report on the privatization options for the Workers Compensation Fund ("WCF"). This report is a high-level analysis of options regarding the proposed privatization of the WCF.

We have enjoyed working with the State on this analysis. Please give us a call if you have any questions or comments.

Sincerely,

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I. Introduction

Study Objectives

Deloitte & Touche LLP ("D&T") has been retained by the State of Utah Governor's Office (the "State") to provide a written report ("Report") of a high-level analysis of options regarding the proposed privatization of the Workers Compensation Fund ("WCF"). In our Report, we provide a discussion of the potential impact of alternative organizational structures on issues such as premium levels, market stability, WCF financial stability and how these issues in turn could impact the State, WCF policyholders, the workers compensation residual market, and the citizens of Utah.

Alternative organizational structures which are discussed include:

- Reversion to a Governmental Agency
- Maintenance of Status Quo – Quasi-Governmental entity
- Full Privatization/Mutualization
- Creation of a Stock Company with Issuance of Stock to Policyholders
- A Sale of WCF to a Third Party
- Hybrid Structure

We understand that the Governor will consider this Report and based on his assessment of the State's priorities and potential impacts of alternative organizational structures of WCF, he will make a recommendation to the State Legislature, which may include some form of privatization, the status quo, or possibly having WCF revert to a pure state agency.

To assist the State, our report is broken down into the following major areas with regard to the privatization options for WCF:

I. Introduction;

II. Executive Summary;

III. Background;

IV. Residual Market Alternatives;

V. General Concepts of Value;

VI. Alternative Organizational Structures;

VII. Federal Tax Implications;

VIII. Impact on Policyholders; and

Appendices.

This section is the *Introduction* Section. It summarizes the objectives of the study and describes our data sources and reliances, caveats and limitations of the report, and use and distribution of the report.

Section II (*"Executive Summary")* provides a high-level summary of the study and lays out the options for the organizational structure depending on the needs and priorities of the State.

Section III (*"Background")* includes a general discussion / summary of D&T's understanding of the history of WCF and the Utah workers compensation market, WCF's proposal to privatize, and the current organizational structure of other workers compensation funds in selected states.

Section IV discusses the potential residual market structures available to the State of Utah for its workers compensation risks. We compare and contrast Utah's current residual market model with models / mechanisms used in other selected states, such as an underwriting pool or an assigned risk pool. We comment on a reasonable model(s) after the potential privatization.

Section V discusses generally the different concepts of value as they might pertain to WCF, such as Statutory Surplus, Generally Accepted Accounting Principles ("GAAP") Surplus, Excess

Statutory Surplus, Discounted Surplus Value, Economic Value, and Fair Value. In addition, this section will review the impact (if any) of WCF's historical Federal tax exemption on surplus.

Section VI discusses the alternative organizational structures mentioned above. Topics discussed include residual market alternatives, most applicable concept of value for that option, high level risks and opportunities of that option, requirements, and the effect of maintaining or not maintaining the Federal tax exempt status.

Section VII focuses on a high level discussion of how the alternative organizational structures might impact WCF's tax-exempt status under the specific provisions of Internal Revenue Code Section 501(c)(27)(B).

In Section VIII, we comment on other potential privatization issues, such as potential future demutualization and its likely effects (benefits and costs) on policyholders and the State's workers compensation market in general, the likely effects on market conditions and the competitive environment, the impact on workers compensation rates post privatization, the shift of policyholders among insurers after the privatization, the expansion of WCF into other states, and potential changes in the WCF employee culture as a result of privatization.

Data Sources

In this analysis, we have relied upon data and information supplied by, or compiled from discussions with, responsible employees / staff members of the following companies or public agencies, or obtained directly from their respective websites:

- WCF;
- Utah Department of Insurance;
- Utah Governor's Office;
- National Council of Compensation Insurance (NCCI); and
- WCF's Consulting Actuary.

Caveats and Limitations

We understand that the Governor's Office, WCF's management, and the Utah Department of Insurance have provided us with all of the relevant information that would materially affect our Report. To the extent that new information is provided, we reserve the right to add or revise comments as appropriate.

The comments, suggestions, and recommendations made in this report are based on our understanding of the State Insurance and IRS regulations as of today. We are not aware of any potential changes in the State Insurance or IRS regulations due to the legislative action or judicial / IRS interpretation that may affect our opinions. However, if future legislative action or judicial / IRS interpretation affect the operations of WCF, then our comments may no longer apply.

We want to emphasize that there remains a significant amount of uncertainty with regards to WCF, particularly with respect to its Federal tax exemption status. Hereafter, all reference to tax exemption is relative to Federal status. As mentioned below, the tax-exempt status ruling has not been fully developed and the IRS has not yet given clear guidance. Accordingly, we may not be able to give definitive answers to all of your questions and, therefore, have provided only a high-level summary of some of the tax issues.

D&T has performed the work consistent with the scope outlined in the engagement contract with the State and in accordance with accepted standards of practice for the intended use as described in the **Distribution & Use** section. In preparing this report, it was assumed that the report will be utilized by persons competent in the areas addressed. Judgments as to the conclusions drawn should be made only after studying the report in its entirety. D&T staff members are available to explain and/or amplify any matter presented herein subject to the terms in our engagement contract. It is assumed that an authorized user of this report will seek such explanation and/or amplification as to any matter in question.

The performance of the services hereunder does not constitute (i) a recommendation regarding the acquisition or financing of any business, assets, liabilities or securities, (ii) a market or financial feasibility study, (iii) a fairness or solvency opinion, or (iv) an examination or compilation of, or the performance of agreed upon procedures with respect to, prospective financial information in accordance with standards established by the American Institute of Certified Public Accountants ("AICPA"). The services hereunder are not intended to be, and shall not be construed to be, "investment advice" within the meaning of the Investment Advisers Act of 1940. It is understood that D&T is not providing, nor is it be responsible for providing, legal advice hereunder. In addition, financial forecasts are the responsibility of the State or WCF, as the case may be. In this regard, the State or WCF, as the case may be, is responsible for representations about plans and expectations and for the disclosure of significant information that might affect the ultimate realization of its forecasted results. D&T, therefore, has no responsibility for the achievability of the results forecasted by the State or WCF. There will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

The State has acknowledged that D&T is unable to express, and will not express, an opinion or other form of assurance concerning the merits of any proposed stock or sale transaction or any other matter related to this engagement or the fairness of the contemplated terms thereof. In addition, the State acknowledges that D&T's engagement does not constitute an audit made in accordance with generally accepted auditing standards, the object of which is the expression of an opinion on the elements, accounts, or items of a financial statement. D&T's engagement is limited in nature and does not comprehend all matters relating to WCF that might be pertinent or necessary to WCF's, the State's or any other person's evaluation of a proposed transaction. The report cannot be relied on to disclose errors or fraud should they exist and D&T's services hereunder do not address all the questions that a prospective acquirer or investor may have.

If the sale of WCF is pursued, the State hereby releases D&T and its personnel for all claims, liabilities, and expenses relating to any acquiring company's access to any materials prepared or provided by D&T, including, without limitation, claims, liabilities and expenses resulting from the termination of, or change in, the proposed transaction.

Distribution and Use

It is understood and agreed that D&T's services may include advice and recommendations, but all decisions in connection with the implementation of such advice and recommendations shall be the responsibility of, and made by, the responsible employees or representatives of the State.

The report's conclusions are developed in the accompanying text, exhibits, and tables, which together comprise the report. This report is prepared solely for the use of the Governor's Office and Staff, and is intended to assist them in assessing the alternative organizational structures for WCF. It is not intended for other purposes. In addition, because of the specific facts involved, this report should not be provided to, nor relied upon, by third parties. Any other use or distribution of this report must be preceded by our written consent.

This report should be considered in its entirety. If this report is distributed with our consent, it should be distributed in its entirety (with discussions, exhibits, and tables). D&T consultants are available to answer any questions that might arise in reviewing this report.

II. Executive Summary

The State's selection of an alternative structure for the WCF depends on the State's prioritization of the risks and opportunities for each alternative. The alternatives also have important implications, on policies, as discussed below. We address these risks and opportunities in detail in Section VI of this Report.

During our conversations with the various parties, a common theme emerged: an overriding concern for the policyholders and impact on the workers compensation residual market in Utah. In addition, we know that the impact on WCF is important, as are the State's interests. Thus, we focused our analysis in these areas.

The WCF reports that Utah currently has the second lowest workers compensation premiums in the nation, which indicates that the current structure appears to be working effectively. The trend in the marketplace is for rates to increase. Workers Compensation results tend to move in cycles. In the early 1990's the countrywide trend was for benefit reform, cost control, and premium level increases. As the effects of these actions were reflected in more favorable results, carriers became more competitive in the marketplace. That cycle ran its course until approximately the events of September 11, 2001. Reinsurance costs then increased significantly, impacting the premiums required by primary carriers. Also, underlying costs such as medical expenses, which had been more moderate for years, started to escalate. In addition, investment returns have decreased so that carriers generally, including the WCF, are less able to offset underwriting losses with investment returns.

Therefore, the impact of alternative structures on Utah's policyholders should be considered in the context of the underlying trends. The trends are exemplified in the National Council on Compensation Insurance (NCCI) estimates that the combined loss ratio for Utah workers compensation business for accidents occurring in 2002 is 125%. This implies that for every dollar of premium paid, workers compensation insurers pay out $1.25 in losses and expenses.

Following are our high level observations on the alternative organizational structures and its effects on the varying types of policyholders. In order to comprehend certain observations in their appropriate context, below is a summary of the current distribution of WCF policyholders by size of premium. This distribution of current policyholders should be considered when reviewing the comments below. We would point out that over 62% of the WCF policyholders (18,137 policyholders) currently have a premium of $2,500 or less:

WCF Policyholder Distribution

Premium Range	Number of Policies	2002 Written Premium	Aveage Size of Policy
< $401	6,374	$2,537,738	$398
$401 - $1,000	5,547	$3,496,583	$630
$1,001 - $2,500	6,216	$10,270,241	$1,652
$2,501 - $10,000	7,543	$37,249,157	$4,938
$10,000+	3,392	$136,748,090	$40,315
Total	29,072	$190,301,809	$6,546

Status Quo

If the State were to leave the WCF as is, then the State would likely be assigning high priority to shorter term availability and cost. This alternative would continue to support subsidizations to the residual market and minimum premium (or small) policyholders. The WCF estimates that its current loss ratio for these groups is higher than for the remainder of its book. We note that the WCF, under this alternative, would have a longer term focus on leveling cross-group subsidization. The State would be essentially adopting a policy that the WCF would be less proactive in responding to the needs of employers which have operations out of state, because many states have statutes that prohibit an insurer from writing business if the insurer is owned or controlled by a State. Under this alternative, those employers who have Utah and other state exposure may over time seek coverage from a carrier that can cover their Utah and non-Utah exposure. The WCF notes that the Utah loss ratio on this business has out-performed the average of its book. Over time, losing this business would likely generate upward pressure on rates. Neither the State nor the policyholders would recognize shorter term, significant value from this alternative, although the WCF would continue to pay policyholder dividends.

A major factor in the WCF's workers compensation premiums being low while paying policyholder dividends is that WCF has accumulated significant assets over its 86 year history. The current premium volume in relation to its assets is relatively small. Therefore, the WCF has been able to offer insurance at significantly reduced prices, especially when considering return premiums in the form of policyholder dividends. This is evident in reviewing the following summary of WCF results over the past five years.

WCF Combined Ratio including policyholder dividends (1998 – 2002):	**133%**
WCF Net Investment Gain as a % of Premium (1998 – 2002):	**30%**

WCF's combined ratio means that over the past five years, for every dollar of premium paid by policyholders, WCF paid out $1.33 in losses. Although, these losses on the insurance written by WCF have been almost completely offset because for every dollar of premium, WCF has earned $0.30 on its investments. These results should not be misinterpreted to mean that WCF has been getting a 30% return on its investments. On the contrary, its return on assets has been a conservative 4.8% during this timeframe. The issue is that the amount of premium written by WCF in relation to its assets is relatively small. Therefore, even when significant negative profits are experienced on the insurance that is written, the investment returns have been enough to offset these losses.

This is one of the main reasons why WCF currently has 60% of the workers compensation market in the State of Utah. WCF can in the short term keep workers compensation premiums lower than its competitors by using its investment earnings to offset the losses on the insurance premiums. Insurers in the past have not been able to compete with the WCF on price because they are not structured the same as WCF.

It must be understood that any alternative structure that removes a certain amount of WCF's assets or changes its organizational structure (i.e. stock or sale) will put pressure on workers compensation premium increases (net of policyholder dividends) in the State. On the other hand, Status Quo is no guarantee that rates won't increase. As discussed above, if WCF is not allowed to write out of state exposures, some of the most profitable business may go elsewhere for insurance putting pressure on premium increases on the remaining policyholders that were being subsidized by the most profitable policyholders.

Revert to State Agency

If the WCF were to revert to a State Agency, the State would likely be assigning a high priority to a policy of significant control over the workers compensation market in Utah. The State would be in the insurance business and have liability for the results of a state agency. As such, the State would have to develop an operational budget for the agency, including but not limited to rate levels, loss and loss expense, other expense, and investment policy. Neither the State nor policyholders would realize much, if any, value from such organization. The State would have virtually total control on establishing policy to pool risk, with costs in one group possibly being subsidized by another.

Independent Mutual, Carrier of Last Resort

Under this alternative the State would likely be giving higher priority to a policy which allows the WCF to insure policyholders with non-Utah operations, and the State relinquishes control of the Board appointment of five of seven Board members by the Governor. The State would also likely be supporting a diversification strategy for the WCF which could result in reducing WCF's concentration of risk in the northeastern urban corridor of Utah. Subsidies for the residual market and minimum premium (small) policyholders might continue about as is, noting again WCF's longer term focus on leveling cross-group subsidizations. Retaining the Federal tax exemption under this alternative would likely continue to provide a pricing advantage across all policyholder groups. The WCF might pay the State for its controlling interest in the Board, as well as for other considerations of ownership. Policyholders would likely continue to receive policyholder dividends. The most relevant value concept under this alternative is Excess Statutory Surplus, because it considers that WCF will continue to operate as a stand-alone insurance company group and, as such, will need to maintain a statutory surplus amount sufficient to meet the Utah insurance regulations.

Independent Mutual (No restrictions)

Under this alternative, the State continues to have a policy which supports WCF's strategy. The WCF would no longer have a Federal tax exemption. The State would need to implement a new residual market mechanism, such as that supported by the NCCI. The State would support a policy that may accelerate the elimination of cross-group subsidizations. We have noted that such mechanisms have been successfully implemented and work well in many states, assuming that sufficient lead time is allowed for implementation.

We note that the NCCI, if it were selected to administer the mechanisms, would file residual market rates with the Utah Insurance Department, and that such rates would likely be targeted to be "self-supporting", thus removing some of the subsidization. Also, for minimum premium residual market risks, the minimum premiums are expected to vary by classification from $275 to $750 from $400 currently charged by the WCF.

In 2002 the WCF had 6374 policies with premiums not exceeding $400, according to the NCCI. It is unknown as to how many of those policies the WCF might cede to a residual market mechanism.

As in the previous alternative, the WCF might pay the State to relinquish its controlling interest in the Board, as well as for other considerations of ownership. Policyholders would likely continue to receive policyholder dividends.

The loss of the Federal tax exemption would create a more "level playing field" for other carriers in the state, and might increase competition, thus controlling rates to some extent.

The most relevant value concept under this alternative is Excess Statutory Surplus, because it considers that WCF will continue to operate as a stand-alone insurance company group and, as such, will need to maintain a statutory surplus amount sufficient to meet the Utah insurance regulations.

Demutualize into an Independent Stock Company or Sell WCF

For these alternatives, the State's policy would be similar in the following respects to those discussed in the previous section.

- Support for geographic expansion and decreasing concentration of risk

- Relinquishing control of the Board of Directors through the Governor's appointments

- Implementation of a residual market mechanism such as those administered by the NCCI in other States, with the impact on policyholders which accelerate the elimination of non-group subsidies

- Payment to the State for relinquishing Board control and other considerations of ownership.

- Increasing competition through implementation of a "more level playing field"

The following observations may help to distinguish the stock vs. mutual alternatives (no Federal tax exemption and no carrier of last resort)

There is much debate and discussion as to whether mutual companies have a pricing advantage over stock companies. We assume that the pricing implications between a stock company and mutual company, are not significant, but do exist. A stock company will generally have to be more efficient than a mutual company to be competitive in pricing and may have a different investment strategy. Mutual companies return value to policyholders through dividends, which are deducted from income before Federal income tax. Stock companies return value to stockholders (or the policyholders if demutualized) after Federal income tax.

Thus, it appears that, all else equal, a stock company would require more income to return similar value, and retain the same capital. The trade off to a policyholder would be possibly increased premium in exchange for ownership value which can be more easily liquidated, assuming dividends were about the same. In addition, the investment bankers advising the State, Houlihan Lokey Howard & Zukin Financial Advisors ("Houlihan"), concludes that the value of the WCF as a Stock company (or through a transaction where the company is sold) is greater than the value of WCF as a mutual.

We note that these are very complex issues that are not easily quantified. The most relevant value concepts for these options are the economic value and the fair market value. The economic value is often thought of as a "floor value" and is often the initial step in a "fair value" opinion. Fair value is only briefly discussed in this report. As stated above, the State has retained Houlihan to evaluate the fair market value of such a transaction. We refer you to Houlihan's report for a "fair value" opinion under the Stock company alternative or sell alternative.

This alternative has more economic risk, upside and downside for both the company and its policyholders (or future stockholders), than a mutual insurance company. It will have a greater focus on quarterly results and greater growth and profitability expectations which might strain the resources of a newly capitalized stock company. It also may be more complex to implement than a mutual company. <u>Assuming</u> it is successful and stays in Utah, it could have a significant positive <u>economic</u> impact over time.

Other Comments

If the State wants to stimulate competition, then either Full Mutualization of WCF (no restrictions), the formation of a stock company, or the sale of WCF may be the most appropriate options for the State.

We have also noted risks and opportunities with respect to the structural alternatives on the operations, management and employees of WCF. The conversion of WCF to a fully independent mutual insurance company or stock company would be expected to result in changes in business strategy, focus, culture, capital requirements, pricing, profitability and other areas. We have noted some of the major considerations in the risks and opportunities, but this is not meant to be all-inclusive. We have not spent sufficient time with WCF management or analyzing WCF's operations to fully understand the issues WCF would face in the scenarios. This was beyond the scope of engagement.

There are also various regulatory and implementation implications associated with the alternatives that must be addressed. The current quasi-government agency status presents various legal hurdles and opportunities, many of which can be impacted by legislative action. Thus, we have not disregarded any alternatives based on potential regulatory or implementation issues.

In summary, each structure has its own risks and opportunities that should be carefully considered in the decision making process. It should also be noted that there are potential variations of each structure that could be developed to mitigate issues or complexities in implementation. For example, potential complexities associated with demutualizing into a fully independent stock company can be reduced by a phased approach over a period of several years. The risks and opportunities are heavily dependent on the capability of WCF management to execute a given strategy, the economic and workers compensation environment, and the extent to which the selected strategy is appropriately supported by legislation to implement the strategy. Success and failure have been observed at both ends of the spectrum of possibilities.

In the case of the WCF, management has a proven track record of success, supported by a workers compensation system with a reasonable balance between benefits and premiums. The selection of a specific alternative by the State depends on the State's priority for policyholders, the WCF and the State itself, as well as on the State's assessment of the likelihood of the respective risks and opportunities.

III. Background

Brief History of WCF

During the early 1900s, state legislatures throughout the United States recognized the need for a system of workers compensation insurance. The Industrial Revolution had dramatically increased the number and severity of work-related injuries. Injured workers were unable to receive medical benefits and wage compensation. Civil lawsuits against employers took years to settle and employees often ended up depending on welfare or the charity of others.

In 1917, the Utah Legislature passed the Workers Compensation Act, requiring all employers to obtain workers compensation insurance coverage. In addition, WCF was created to provide competitively priced insurance to Utah employers. We understand from WCF that the Legislature appropriated $40,000 from the State Treasury for WCF to begin writing insurance and that the loan was repaid in four years.

From 1944 until 1988, WCF (under various names such as the "State Insurance Fund") operated as a State Agency of Utah and was administered by the Utah Industrial Commission. A formal organizational study of WCF was completed in 1987. The study recommended autonomy for WCF from State administration by establishing a quasi-public corporation with five of seven members of the Board of Directors appointed by the Governor. A quasi-public corporation has been defined to us as a privately-owned corporation with public purpose. In this case, WCF's public purpose is to act as an insurer of last resort. This action was approved by the State Legislature in 1988 and WCF has operated financially independent from the State since 1998.

WCF currently insures more than half of all Utah employers. Companies of all sizes and industries rely on WCF for workers compensation coverage. In addition, as mentioned above, WCF acts as a market of last resort for Utah workers compensation business. As such, WCF is required to insure any and all business that cannot otherwise purchase workers compensation insurance in the competitive marketplace.

WCF believes its longevity and financial strength are important factors to employers when they select a carrier. WCF is recognized by the insurance industry's leading rating companies, A.M. Best (A-, Excellent) and Standard & Poors (Api, Strong). According to A.M. Best, WCF's A-minus rating reflects the company's excellent financial strength, strong reserving practices and dominant market position. A.M. Best also reports that the rating acknowledges WCF's unparalleled local presence and excellent reputation for a high level of service and profit sharing.

WCF believes its efforts to reduce accidents and control costs have contributed to a decreased accident frequency, stable premium rates, and dividend increases. For nine consecutive years, WCF has paid customers dividends that total more than $120 million.

Longstanding Identity as a State Fund

WCF is a member of the American Association of State Compensation Insurance Funds, or AASCIF, which is an association of workers compensation insurance companies from 27 different states, plus 11 workers compensation boards in Canada. The AASCIF website indicates that in the US, these companies – loosely referred to as state funds – each specialize in writing workers compensation insurance in a single state. Some of these companies operate as private insurance companies, whereas others act as agencies of their respective state governments.

Some background information with regards to state funds and their objectives is provided below. This information is directly from the AASCIF website:

> "The role of state funds is as longstanding as workers compensation systems. With enactment of state workers compensation laws, the need for workers compensation insurance created its own set of problems. Employers feared they would be forced out of business if refused coverage by insurance companies. They were also fearful that insurance carriers might impose excessive premium rates that would be a financial burden. High premium rates could negatively affect a state's economy and ultimately limit opportunities for employment. Another fear was that insurance rates might soar, enabling insurers to reap unfair profits. Legislators addressed these concerns by establishing state workers compensation insurance funds. These funds were created to provide a stable source of insurance coverage, thus protecting employers from

underwriting uncertainties by making it possible to have continuing availability of coverage.

Since state funds were designed to be nonprofit, premiums could be kept at the lowest possible cost for employers consistent with financial solvency. In addition, the funds were established solely to provide one type of insurance: workers compensation. This specialization allowed the funds to concentrate resources, knowledge and expertise in this field of insurance. Since the early 1900s, availability, affordability, and service have been the key benefits of state funds.

State funds are, by law, designed to be self-supporting from their premium and investment revenue. As nonprofit departments of the state, or as independent nonprofit companies, they are able to return dividends or safety refunds to their policyholders. This reduces the overall cost of workers compensation insurance.

State funds, for the most part, are subject to the same regulatory requirements as private companies, in terms of surplus and reserves. Major independent accounting and actuarial firms validate the funds' financial position and reserves."

Based on everything that we have heard and read, the above description fits WCF. Its goal has been to be self-supporting from its premiums and investment income while maintaining the lowest possible cost for workers compensation insurance.

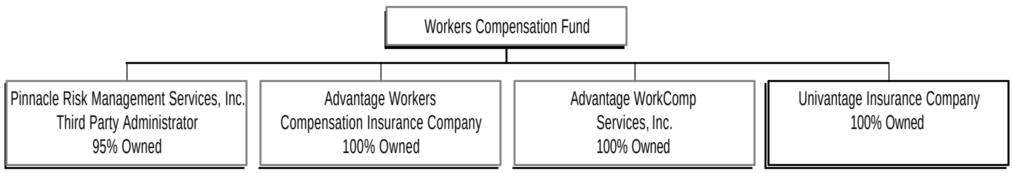
See Appendix A for a listing of the 27 state funds in existence and their forms (e.g., monopolistic or competitive).

Organizational Structure and Operations

According to WCF's website, WCF now employs more than 330 employees in three offices, Murray, Odgen and St. George.

Although WCF is not specifically designated as a mutual insurance company in the Utah State Statutes or Insurance Code, WCF management refers to WCF as a mutual insurance company, designed to act in the best interest of their policyholders and employees. In addition, we understand that WCF is a licensed insurer subject to the jurisdiction of the Utah Insurance Commissioner and that it is regulated substantially like a mutual insurance company.

Over the past few years, WCF has acquired an interest in several entities to sell workers compensation products and services to clientele in the Western United States. The following shows the current organizational structure of the WCF:



A brief description of the subsidiaries is provided below. WCF owns or substantially owns four subsidiaries:

- *Pinnacle Risk Management Services, Inc.*, which is a third party claims administrator for both workers compensation and liability claims. It is a market leader in Utah and Oregon and has offices in Arizona, California, Idaho, Nevada, New Mexico, Oregon, Pennsylvania, Utah, and Washington. It has approximately 230 employees and is owned 95% by WCF. It represents a platform for selling unbundled services.

- *Advantage Work Comp Services, Inc.* is organized to provide services to workers compensation insurance companies and self-insureds. It is owned 100% by WCF.

- *Univantage Insurance Company* is an inactive company licensed in the State of Utah for health and disability. It is owned 100% by WCF.

- *Advantage Workers Compensation Insurance Company (AWCIC)* has forty-two state insurance licenses (including D. C.). It currently writes business in twenty-four states. It has a reinsurance agreement with WCF, is 100% owned by WCF, and shares in the WCF Group Best Rating (A-).

We understand from WCF management that the purpose of the subsidiary structure is to be able to provide unbundled workers compensation services and to insure workers compensation policyholders outside of Utah. In February 2001, HB 59 was passed which expanded WCF's charter to permit it to offer insurance coverage to out-of-state customers who purchase products, and services from one of WCF's subsidiaries.

Pinnacle provides workers compensation claims and other risk management services to WCF's Utah-based policyholders who have permanent employees in other states. In turn, WCF will provide Pinnacle with broad-based resources, including disability management, safety engineering, fraud detection and computer systems.

Many services have also been added or expanded to meet WCF customer needs. WCF offers its customers multi-state insurance coverage, loss sensitive products and unbundled services. Special investigations, utilization review, medical case management and vocational rehabilitation are now within the Company's portfolio of services at substantial savings. WCF believes its safety programs are of high quality; the Safety Department presents safety seminars covering both basic safety and industry-specific safety to WCF customers throughout the state.

We understand that WCF has no future plans for Univantage Insurance Company and does not plan to write health or disability insurance.

Strategic Objectives

WCF's current strategic objectives are to improve its financial performance and to continue to expand geographically. WCF is looking to improve financial results through reductions in operating expenses and average claims costs, accident prevention programs and incentives, and increases in investment income. In addition, WCF will continue its geographic expansion by writing more of the out-of-state workers compensation business for Utah multi-state accounts, offering workers compensation insurance to new out-of-state accounts, and selling related products and services in other states (e.g., third-party claims administration services, managed care services). WCF believes by expanding into other states, this will help to diversify its insurance portfolio as well as dilute the subsidy of residual market business by the voluntary market.

Board Appointment

WCF is governed by a seven-member Board of Directors. The first two members are the Executive Director of the State Department of Administrative Services, who represents the State as a major policyholder, and the Chief Executive Officer of the WCF (currently Lane Summerhays). The Governor appoints five of the seven members of the WCF's Board of Directors. Members include customers, and insurance and financial business executives. The Board members serve a four-year term. We understand from WCF management that the Board of Directors appoints the CEO and works closely with management to establish a strategic direction.

WCF is Subject to Insurance Department Regulations

WCF operates under the regulatory authority of the Utah Insurance Department. Accordingly, among the more significant regulatory requirements are that it files workers compensation rates and forms with the Utah Insurance Department; it is subject to investment and financial restrictions of the Insurance Code; it files annual and quarterly statutory financial statements with the Insurance Department and with the National Association of Insurance Commissioners; it pays premium taxes; and it is subject to periodic financial examination by the Department. Also, the Commissioner of Insurance has authority to challenge Board appointments, and the Insurance Department would be involved in approving a change of organizational structure.

Relationship to the State of Utah

Although WCF is self-sustaining and operates independently from the State, there are still some relationships which exist between WCF and the State. First the State Governor appoints five of the seven members of WCF's Board of Directors. We understand that these members do not serve at the Governor's pleasure, but they are, nonetheless, appointed by him. Second, WCF is the insurer of last resort in Utah. Third, WCF employees participate in the Utah public employees' retirement system. Lastly, the State is required to purchase workers compensation insurance from WCF. Other states, such as Idaho and California, are arguing that these relationships imply that the State still has some control over WCF.

WCF is a Member of the Guaranty Fund

The WCF is a member of Utah's Property Casualty Guaranty Association. As such, it subject to Guaranty Fund assessments. In addition, in the event of the insolvency of the WCF, the Guaranty Fund would make payments, subject to limits, to the extent the WCF's liquidation value was insufficient to cover policyholder claims.

Why are the State and WCF Considering Privatization?

To understand why privatization would be considered at this point in time, one should have information on the background and perspectives of the WCF, as well as certain State and national trends related to workers compensation. After all, by many measures the State enjoys a sound workers compensation environment. So if the system works well, why consider change?

The State's rationale for change at this time will be based on its consideration of priorities, opportunities, and risks. The WCF is a much different organization now than it was fifteen years ago. If privatized, the WCF could be much different fifteen years hence than it is now. If not privatized, the WCF could still be much different than it is now. The factors contributing to this zenith for potential change relate to the WCF's attempts to evolve so that it can continue to meet the needs of a dynamic State.

In the early part of the last century, a state agency could serve its policyholders well by insuring only the Utah operations of its employers, because so many employers had operations solely with the State. As employers have expanded their boundaries and unbundled their workers compensation program needs, the WCF has pursued an organizational structure that attempts to meet those needs. WCF now owns three subsidiaries which offer insurance and related products and services to multi-state accounts (domiciled in Utah) for their non-Utah operations. These subsidiaries have served both WCF and the multi-state accounts well.

However, there are statutes in other states (approximately twenty one) that substantially limit, or prohibit, the provision of workers compensation coverage and services by an entity owned and controlled by another state. Because of the relationships between WCF and the State of Utah described above, some states are challenging the State of Utah's ownership and control of WCF. For example, in a recent unfavorable ruling in Idaho, WCF was judged to be under the control of the State of Utah and, as such, will be prohibited from offering insurance in Idaho. We understand that action with respect to the recent Idaho ruling has been withheld until November 1, 2003, pending legislation in Utah. A similar issue was successfully resolved in Nevada. WCF has indicated that the loss ratio on the Utah portion of its policyholders who have operations out of state which are insured through AWCIC, is lower than the loss ratio on policyholders for which they insure operations only in Utah.

Therefore, as the State's economy and employers became more diverse, WCF in its present organizational form as a quasi-governmental agency may be limited in its ability to serve existing and potential policyholders.

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We understand that in January 2003, statutory changes were proposed that will allow WCF to become a mutualized insurance company. If the proposed changes become law, WCF will operate as a Utah-domiciled mutual insurance company, independent from the State of Utah, and will remain as the insurer of last resort. In connection with the proposed statutory changes, a settlement agreement and release of claims have been drafted between the State and WCF. The agreement requires that the State of Utah release any and all claims to WCF's assets, and as consideration, WCF pay $50 million to the State.

After considering action, the Legislature and the Governor decided that more information was needed before a privatization proposal could be considered for enactment.

IV. Residual Market Alternatives

A significant consideration in the future organizational structure of WCF will be the mechanism adopted for handling the State of Utah's workers compensation residual market.

Employers are required by law to purchase workers compensation insurance to provide for the cost of its employees' medical care, rehabilitation, and lost wages due to employment-related injuries. In a competitive environment, employers can usually purchase such coverage from one of several insurance carriers licensed in the state. However, some employers are considered "high" risk in the insurance marketplace. Employers may be considered "high" risk for a variety of reasons: account size, poor prior loss experience, uncertain / unstable financial status, or the inherently dangerous nature of the work. These employers often have significant difficulty obtaining coverage in the insurance marketplace and, as such, are referred to as the "residual market" or the "assigned risk market." In order to assist those "high" risk employers in meeting their legal obligations, each state has created a formal mechanism by which those employers can purchase insurance.

There are essentially four types of residual market mechanisms in existence today. This section discusses Utah's current residual market model and compares it to the other three potential residual market options.

Current Mechanism

Currently, WCF is defined by statute as the State's workers compensation market of last resort ("MLR"), and hence by itself is the carrier of last resort ("CLR"). WCF must provide workers compensation insurance coverage to any employers in the State who cannot obtain coverage and who would otherwise be uninsured. There is no proof of declination required (i.e., WCF must offer insurance to all who request it).

WCF, as the CLR, has not established a well-defined criteria for which of its risks would fit a so-called "residual market" definition. This is not necessarily a shortcoming. The WCF has flexibility in how it prices its risks. Therefore, if the WCF can achieve reasonably consistent results across market segments, it is not particularly critical to describe a particular market segment as "residual" or "involuntary".

Nevertheless, WCF has, in recent years, established a framework to "score" risks by underwriting criteria. Based on this system, the WCF has a general indication of which risks would be residual market risks if WCF were not the CLR. The WCF believes these risks represent about 8% to 10% of their total book. This percentage is not inconsistent with national norms at this time. The percentage of the market which is deemed "residual" varies with the workers compensation underwriting cycle. As rates become more adequate (i.e., premium received fairly compensates the insurer for insurance coverage provided), the size of the residual market decreases, and vice-versa.

Based on our discussions with WCF and the Insurance Department, we do not have indications that there are problems with the State's designating WCF as the CLR. In fact, the process seems to be well integrated into WCF's general underwriting process. If an insured could not obtain coverage from another carrier, they would go to the WCF and obtain coverage. The risk is again not formally designated as a residual market risk by the WCF.

The WCF does not pool or share its MLR financial results with other carriers in the State. It simply absorbs them into its results. However, in doing so, WCF qualifies for a Federal tax exemption under Internal Revenue Code ("IRC") 501(c)(27)(B), which provides an exemption from Federal income taxation under IRC 501(a) to "any organization (including a mutual insurance company)" that meets certain requirements. Please see Section VIII for a more detailed discussion on IRC 501(c)(27)(B).

Based on our discussions with the DOI, insurance brokers, and WCF, the CLR approach appears to be working effectively in Utah. The tax exemption has helped keep the rates low and insurance affordable for this market segment. The servicing of these accounts has been good.

There has been no differentiating of accounts by WCF, other than its allocating of business into pricing tiers. In other words, no employers have been labeled a "residual market" risk.

Utah is not alone in designating its State Fund as the CLR. The following states have designated their State Funds (or a specific licensed insurance company) to operate as the market of last resort for workers compensation insurance:

- California
- Colorado
- Hawaii
- Kentucky
- Louisiana
- Maine
- Maryland
- Missouri (through Travelers Insurance Company)
- Montana
- Nebraska (through Travelers Insurance Company)
- New York
- Oklahoma
- Pennsylvania
- Rhode Island
- Texas

Residual Market Options:

There appears to be three other alternative residual market mechanisms that Utah could implement rather than the carrier of last resort. These mechanisms are being employed effectively in other states today.

- One state, Florida, has established a joint underwriting association (JUA) to handle its residual market.
- Several states employ an assigned risk mechanism which is administered by the National Council on Compensation Insurance (NCCI).

- Several other states employ an assigned risk mechanism which is administered by the state or an organization other than the NCCI on its behalf.

The following states have NCCI act as the residual market administrators.

- Alabama
- Alaska
- Arizona
- Arkansas
- Connecticut
- Georgia
- Idaho
- Illinois
- Iowa
- Kansas
- Nevada
- Nevada
- New Hampshire
- New Mexico
- Oregon
- South Carolina
- South Dakota
- Vermont
- Virginia

The following states operate their own pool.

- Delaware
- Indiana
- Massachusetts
- Michigan
- Minnesota
- Mississippi
- New Jersey
- North Carolina
- Wisconsin

The assigned risk mechanism is fairly similar across all states, regardless of administrators. An employer after being declined in the voluntary market (number of declinations defined in plan) submits application to the administrator for coverage. The administrator processes the application, determines the premiums, and issues the policy. The premium rates are usually determined such that the residual market business is self-supporting.

After the policy is issued, it is sent to a servicing carrier. One to three insurance companies licensed in the respective state are usually selected to be servicing carriers. For a fee (typically 25% to 45% of premium), these servicing carriers handle the claims administration for the policy as well as offer to the policyholder various loss control and safety programs. The premiums and losses on the policy are then 100% quota shared to the reinsurance pool / mechanism in the State. The reinsurance pool aggregates the experience of all the policies, and any profit or loss is then allocated to all the insurance companies writing workers compensation insurance in the State.

We have found an excellent description of the NCCI plan on its website. With the NCCI's permission, we have reprinted the following information from its website. It provides a significant amount of detail around the plan features, the servicing carriers and how the NCCI selects and monitors those carriers, and the NCCI's role in administering the plan.

NCCI Residual Market Reinsurance Pool

The Plan is the basic instrument through which eligible employers that would otherwise be unable to obtain necessary insurance coverage can secure workers compensation insurance. The Plan includes the state-approved rules that govern the assignment, administration, eligibility and policy issuance requirements.

Common Plan features include:

- Rules for administering, managing, and enforcing the Plan
- Methodology and formula for making assignments to direct assignment and servicing carriers
- Rules for eligibility and assignment of assigned risk applications
- Eligibility criteria for appointing servicing carriers
- Written performance requirements for servicing carriers (see below)

- Procedures for administering the dispute resolution mechanism
- Residual market operating rules and forms
- Provisions for informing regulators of any insurer that is not participating in the Plan

Plans generally require that carriers licensed to write workers compensation insurance in the state participate in the Plan in an equitable manner. Since the residual market consists of employers outside the voluntary insurance market, the Plans provide that these employers be distributed among the insurance carriers based on each carrier's voluntary market share participation in the state from the preceding calendar year.

NCCI administers Plans on behalf of insurance regulatory authorities in 20 jurisdictions. As the Plan Administrator, NCCI:

- Establishes eligibility requirements for residual market coverage
- Screens applicants to establish eligibility
- Processes over 100,000 applications annually and binds coverage on behalf of both direct assignment and servicing carriers
- Collects and maintains information on policy data, collections, experience rating, etc.
- Interprets the Plan rules and procedures; devises new rules and procedures and files them with the state regulators
- Develops, implements and supports pricing and rating programs approved by the regulators
- Ensures equitable distribution of residual market business among all assigned carriers
- Identifies and informs regulators of carriers not fulfilling their Plan participation obligation
- Establishes and conducts the servicing carrier bid process where approved

While the Plan provides the mechanism through which to distribute employers equitably among participating insurance carriers, each carrier receiving an employer is subject to the possibility that the employer might present exposures not totally within the expertise of the carrier or may include the risk of catastrophic loss. The state's response to these unpredictable exposures is a residual market reinsurance pool. The pool is a financial agreement among carriers to share in the operating results of the state insurance plan. The largest of these pooling arrangements is the National Workers Compensation Reinsurance Pool (NWCRP or National Pool).

While the National Pool is "national" in name and affords administrative efficiencies and conveniences to carriers and insureds across many state lines, its financial structure is state-specific. Carriers share in the Pool results for those states where they are participating, in proportion to their share of the total voluntary market for workers compensation in that state.

As the administrator of the National Pool, NCCI:

- Serves as a central source of information relative to Pool transactions and is responsible for the Pool's business and financial operations
- Handles Pool financial reporting procedures, premium calls, quarterly distribution of operating results, Pool investments, and all other financial administrative obligations
- Determines residual market pool reserves on a quarterly basis
- Maintains Pool membership information
- Monitors and enforces the performance of servicing carriers on behalf of the Pool
- Conducts on-site and self-audit programs to confirm servicing carrier compliance with performance benchmarks and implements disciplinary action as appropriate

The Process for Selecting Servicing Carriers

In its website the NCCI states:

The selection of servicing carriers is a key component in ensuring proper service in the residual market. NCCI has experienced phenomenal success with this initiative, which seeks to provide residual market stakeholders with a consistent quality of service at the most competitive price. See Servicing Carrier Performance Standards.

The bid process has been completed over 40 times since 1993 and has resulted in savings of more than $200 million. In addition to these outstanding cost-saving results, the bid process has also increased the rate of depopulation of the residual market and increased the overall quality of service to the insureds in each state where it has been implemented.

The bid process was fine-tuned with the input of carriers, regulators, producers, and outside consultants. Realizing the differences in the size and complexity of jurisdictions, NCCI created a number of Request For Proposal (RFP) options. While each choice is significantly different, similarities do exist. These options can be used as is, or adapted to meet the individual needs of the specific jurisdiction. In every case, as stated before, the final RFP is the result of feedback from regulators, carriers, agents, and insureds. Each RFP has been designed to be fair and objective to all carriers regardless of size and past status as servicing carriers. To motivate servicing carriers to improve their individual results, several RFP selections offer the carrier the opportunity to further "guarantee its results" by putting a portion or all of its servicing carrier allowance at risk, thereby sharing in the results it will deliver for each state. The bid process rewards those carriers offering the most competitive prices balanced with the most creative and innovative ways to service the residual market including:

- Underwriting the residual market insured properly
- Adjusting claims fairly and timely
- Providing quality loss control/prevention services
- Collecting appropriate premium
- Providing quality customer service
- Managing and containing medical costs
- Identifying and deterring premium, claims, and third-party fraud

NCCI administers all of the functions necessary to properly select bid winners from a group of proposals. The proposals are in response to a prescribed RFP.

These functions include:

- Preparation of custom Requests For Proposal

- Threshold eligibility criteria:
  - Percentage of voluntary writing
  - Presence of a local office
- Number of carriers to service the residual market
- Length of contract
- Location of the bid conference
- State-specific managed care needs
- Ongoing conditions that must be met
- Weighting system to determine the most qualified bidder
- Determination of who makes the final selection
- Determination of how the selections are made
- Preparation and presentation of bid conferences
- Selection of successful bidders
- Announcement of successful bidders
- Administration of an appeals process

V. General Concepts of Value

One goal of this report is to assist the State in the evaluation of its and the policyholders' potential interests, if any, in WCF. In order to evaluate any such interests, several different concepts of value need to be discussed. The concept of value is often debated in several ways and is subject to different interpretations. D&T's analysis is not intended to provide a specific value for WCF. Rather, the analysis discusses several different concepts of value and explains the different circumstances under which each concept may be relevant. In addition, for each concept, the analysis provides a range of indicated value amounts based on relevant statistical diagnostics.

We note that the scope of our work does not include an opinion on who ultimately owns the value, if any, of WCF (e.g., the State of Utah or the policyholders). Our scope is limited to a high-level discussion of the different concepts of value and how they might pertain to WCF. The ultimate ownership of any such value is, in and of itself, a difficult and complex issue that is not answered in this analysis.

Concepts of Value

Currently, there are many methodologies used to value an insurance company or block of insurance business. The specific method used often depends on the purpose of the valuation and how the interested parties will use it. Often, there is no single correct or best methodology (or value amount), and two or more valuation methods are used to estimate a range of values. D&T's intention here is to discuss the more common concepts of value and provide sufficient output and diagnostics to allow a reader to develop his or her own conclusion with regard to the value of WCF. If relevant, we also provide various comments and interpretations of the output and diagnostics.

The most common concepts of value for insurance companies are the following:

- Statutory Surplus (Multiple of Statutory Surplus Value);
- GAAP Surplus (Multiple of GAAP Book Value);

- Excess Statutory Surplus Value;
- Discounted Surplus Value;
- Economic Value; and
- Fair Market Value.

Over the next several pages, we separately discuss each of these concepts and the circumstances (or alternative structures) under which each concept may be applicable. In addition, for the first five concepts, we provide a reasonable range for the estimated value under that concept. For fair market value, we only provide a high-level discussion of the concept. Any estimation of WCF's fair market value is beyond the scope of our work. We understand that the State has separately engaged an investment firm to estimate the WCF's fair market value.

Value Concept 1: Multiple of Statutory Surplus Value

Definition

Some insurance companies report results on a statutory accounting basis only (e.g., a mutual insurance company). The commonly accepted approach to estimating the value of such a company is at a multiple of its statutory surplus value. Statutory surplus represents the net statutory balance sheet value (total assets less total liabilities) for that company. However, it does not reflect any goodwill associated with its name and business. Therefore, many transactions are expressed as a multiple of statutory surplus, and the multiple is usually in excess of 1.0. The portion of value in excess of statutory surplus represents the value of goodwill. Also, it is sometimes possible for a transaction to have a multiple less than 1.0 if, for instance, the company is believed to be under reserved or the returns on surplus are low.

The total value attributable to goodwill is very subjective because the individual components of goodwill for an insurance company are difficult, if not impossible, to estimate. The most relevant components of goodwill for an insurance company include its name and reputation, distribution, infrastructure and customer list. It is sometimes possible for a company to have negative goodwill in situations involving bad management, negative publicity, under-reserving, etc.

Analysis

An actuarial opinion on the reasonableness of reserves, and an understanding of where the company's carried reserves fall within a range of reasonableness, are extremely important in analyzing statutory surplus (or value). Any deficiency or redundancy in the reserves can greatly impact the statutory surplus value. WCF recently engaged a reputable international actuarial consulting firm ("the Actuary") to provide a reasonable range for WCF's undiscounted loss and loss adjustment expense reserves required as of December 31, 2002. A large amount of variability is associated with WCF's workers compensation loss estimates because of, among other things, the long-tail nature of workers compensation claims and the uncertainty around future medical inflation. This variability makes it difficult to estimate WCF's workers compensation reserves. Therefore, the Actuary produced a range of reasonable reserves to quantify the variability of the reserves. We discuss this concept of variability in more detail later in the discussion of excess statutory surplus value (see "Value Concept 3" below).

The Actuary's estimated required reserve range as of December 31, 2002 for WCF, net of reinsurance, is $504 million to $565 million with the mid-point of the range at $535 million. This compares to WCF's recorded reserves as of December 31, 2002 of $549 million. We note that WCF's recorded reserves fall within the Actuary's range and that they exceed the mid-point of the Actuary's range by $14 million ($549 million - $535 million). The reasonable range for reserves also implies a reasonable range for statutory surplus, all other things being equal. The Actuary's estimate suggests that if the mid-point of the reserves was recorded, then statutory surplus would increase by $14 million. Correspondingly, if the low end of reserves was recorded, statutory surplus would increase by $45 million, and if the high end of reserves was recorded, it would decrease by $16 million.

The reserves discussed above are all stated on an undiscounted basis. This means that they have been estimated ignoring the time value of money. Workers compensation reserves are not statutorily permitted to completely reflect the time value of money. This treatment of workers compensation reserves is different than for life insurance reserves where estimated loss reserves do reflect the time value of money. Therefore, statutory surplus for workers compensation insurers may have a certain amount of implicit equity since the time value of money is not reflected. Although required by law, this treatment of reserves may be considered conservative.

WCF has recorded its reserves above the mid-point, which is more conservative than required statutorily. Workers compensation insurance companies are allowed to reflect some discounting of indemnity loss reserves. These discounts are determined by referencing actuarial tables that incorporate interest and other assumptions to a reasonable determinable payment stream. These are called “tabular discounts”. Tabular discounting is allowed on workers compensation permanent total claims (e.g., “pension cases”). The consulting actuary has estimated that these tabular discounts total $16.0 million for WCF using an interest rate of 3.5%. WCF’s reserves are reported gross of these tabular discounts.

Summary

Table 1 on the next page adjusts WCF’s recorded surplus to reflect the two adjustments discussed above. The table shows that after adjusting the recorded reserves to the Actuary’s mid-point and including tabular discounts, WCF’s statutory surplus or value would be $250 million, or $30 million greater than the amount recorded. If the recorded reserves are set at the low end of the Actuary’s reserve range and tabular discounts are used, then statutory surplus would be $61 million greater than recorded. If the recorded reserves were set at the high end of the Actuary’s range, the increase in the reserves would completely offset the tabular discount, and the adjusted statutory surplus equals the recorded statutory surplus.

As mentioned above, a multiple of statutory surplus approach is typically used only when statutory surplus is all that is reported. In most situations, using a multiple of statutory surplus as the value of a company may not be the most appropriate approach because of the conservative nature of some of its balance sheet items (e.g., loss reserves do not reflect the time value of money; acquisition costs are expensed as incurred; etc.).

Table 1

Restatement of WCF Statutory Surplus
($ Millions)

	Actuarial Low	Actuarial Mid-point	Actuarial High
(1) Actuarial Loss & LAE Reserve	$504	$535	$565
(2) Tabular Discount	(16)	(16)	(16)
(3) WCF Recorded Reserves	549	549	549
(4) WCF Recorded Statutory Surplus	220	220	220
(5) Restated Statutory Surplus = (4) + (3) - [(1) + (2)]	281	250	220
(6) Additional Statutory Surplus = (5) - (4)	**61**	**30**	**0**

Value Concept 2: Multiple of GAAP Surplus Value

Definition

This concept is similar to value concept #1. Value is measured as a multiple of surplus, except that GAAP surplus is used rather than statutory surplus. The differences between GAAP ("Generally Accepted Accounting Principles") and SAP ("Statutory Accounting Principles" – discussed above) result from their different emphasis. GAAP is intended to measure results of operations and financial condition on a going-concern basis. It places a great deal of emphasis on matching income earned to expenses incurred. SAP, on the other hand, is designed to demonstrate solvency. Adequate statutory surplus provides protection to policyholders and permits a company to expand its premium writings. SAP places a great deal of emphasis on the adequacy of this surplus.

The basis for most states' SAP is the National Association of Insurance Commissioner's ("NAIC") Accounting Practices and Procedures Manual, effective January 1, 2001. As mentioned above, accounting practices and procedures of SAP comprise a comprehensive basis of accounting other than accounting practices generally accepted in the United States of America ("GAAP"). The more significant differences are as follows:

- Acquisition costs, such as commissions and other costs related to acquiring new business, are deferred and amortized to income as premiums are earned; under SAP, they are expensed as incurred.
- Certain assets designated as "non-admitted" under SAP are carried, under GAAP, in the statements of financial condition net of appropriate allowances.
- Under GAAP, investments in bonds are carried at amortized cost or fair value based on their classification according the Company's ability and intent to hold or trade securities. Under SAP, investments in bonds are generally carried at the lower of amortized cost or NAIC market value.
- Under SAP, unearned premiums and unpaid losses and loss adjustment expenses are shown net of reinsurance; under GAAP, such liabilities are presented gross of the effects of reinsurance and the applicable reinsurance recoverables are accrued as assets.
- Under SAP, the change in provision for reinsurance is charged or credited directly through surplus; under GAAP, a provision for reinsurance is not required, but a reserve for uncollectible reinsurance is established based on the credit worthiness of reinsurers with charges in the reserve reflected in income.
- Comprehensive income and its components are not presented in the statutory financial statements.

Because publicly-traded insurance companies report on a GAAP basis, a multiple of GAAP surplus value is often used in valuing such insurance companies. GAAP surplus value represents the net book value of the company (total assets less total liabilities). GAAP surplus value will generally be higher than statutory surplus due to the items discussed above.

Analysis

Currently, WCF is not required to produce GAAP financials. Therefore, no GAAP surplus value was available as of year-end. Subsequent to year-end (and as part of a separate review process being completed by the State's Auditor's Office), WCF was required to complete audited GAAP financials by its certified public accountants. We understand from WCF representatives that the resulting GAAP surplus value from this audit was $81 million greater than statutory surplus.

Summary

Table 2 below adjusts WCF's recorded surplus to reflect both the two statutory surplus adjustments and the total GAAP adjustments. The table shows that after adjusting WCF's recorded reserves to the Actuary's mid-point and including tabular discounts, adjusted GAAP surplus value is $111 million greater than the recorded statutory surplus. The low and high ends of the Actuary's reserve range produce a statutory surplus that is $142 million and $81 million higher, respectively, than the recorded statutory surplus.

Table 2

Adjusted WCF GAAP Surplus
($ Millions)

	Actuarial Low	Actuarial Midpoint	Actuarial High
(1) WCF Recorded Statutory Surplus	$220	$220	$220
(2) GAAP Adjustments	81	81	81
(3) Other Adjustments to Surplus = Table 1, Item (6)	61	30	0
(4) Adjusted GAAP Surplus = (1) + [(2) + (3)]	**362**	**331**	**301**
(5) Amount of Adj GAAP Surplus in Excess of Statutory Surplus = (4) - (1)	**142**	**111**	**81**

Because GAAP surplus is normally readily available, a multiple of GAAP surplus value is one of the most commonly used metrics of expressing a transaction price. Recent multiples of GAAP surplus value have ranged from 0.7 to 3.2, with an average of approximately 1.7.

We note that the GAAP surplus stated above is GAAP as it relates to Governmental Accounting Standard Board ("GASB"). "GASB GAAP" does not represent GAAP on the same basis as other non-Governmental agencies. One of the major differences between GASB GAAP and non-GASB GAAP is the presentation of bonds. GASB GAAP requires that all bonds be carried at fair value. Under non-GASB GAAP, investments in bonds are carried at amortized cost or fair value based on their classification according to the Company's ability and intent to hold or trade securities. It is difficult to know exactly how much WCF's GAAP surplus would change if "GASB GAAP" were not used. However, we note that the majority of the GAAP adjustments from statutory surplus stated above are related to the re-evaluation of the bond portfolio ($80 million). Since WCF most likely classifies many of its bonds as "hold" securities versus "trade" securities, we assume that the amount of GAAP adjustments from statutory surplus would be significantly less than $81 million.

Value Concept 3: Excess Statutory Surplus Value

Definition

The concept of excess statutory surplus is derived from the fact that an insurance company is a regulated entity. Most insurance companies are regulated through state insurance departments and are subject to A.M. Best (Rating) considerations.

Insurers are subject to differing minimum capital and surplus requirements, such as Risk-Based Capital requirements, in the various states in which they conduct business. These requirements have been established by statute to ensure that insurers have sufficient capital to conduct their business, considering the specific characteristics and risks inherent in the insurance industry.

Risk-Based Capital Requirements

To effectively measure the amount of surplus an insurer needs in relation to its size and risk profile, the NAIC established and adopted the **Risk-Based Capital (RBC)** requirement in December, 1993. The RBC requirement is calculated by formula on an individual insurer basis. It takes into account the variety of risks faced by an insurer, such as asset risk, credit risk, underwriting risk and off-balance sheet risk. The final result indicates the amount of surplus required for that specific insurer (i.e., its RBC required). The RBC required is then compared with the insurer's reported statutory surplus (adjusted for certain items). If the insurer's adjusted statutory surplus falls below certain RBC requirements, the insurer will be subject to regulatory action. The information supporting the RBC calculation is submitted each year to the NAIC as a part of each insurer's Annual Statement.

RBC Levels represent four action levels of regulatory or company action. Below is a description of what is usually required at the four different levels.

- Company Action Level (CAL) – The Company must submit a plan of action to the insurance commissioner, explaining how the company intends to obtain the needed capital or to reduce its operations or risks.

- Regulatory Action Level (RAL) – At this level, the commissioner has the right to take corrective action against the company, such as restricting new business. However, all action by the state insurance department is discretionary.

- Authorized Control Level (ACL) – Regulatory action is still discretionary, but the insurance commissioner is "authorized" to take control of the company.

- Mandatory Control Level (MCL) - The insurance commissioner *must* rehabilitate or liquidate the company.

In this report, the excess statutory surplus value is computed as the difference between statutory surplus and the amount needed to operate in the regulatory / risk based capital or minimum surplus environment.

Analysis

In the insurance industry, it is very prevalent to look at rule-of-thumb leverage ratios to determine an appropriate level of surplus. Therefore, the first phase (Phase 1) of this analysis benchmarks WCF's statutory surplus with comparable U.S. insurance companies. The second phase (Phase 2) uses D&T's surplus model to analyze the volatility created by the key risk factors which can potentially impact WCF's financial viability.

<u>*Phase 1 -- Benchmark Study*</u>

This first phase of the analysis compares three different statutory "leverage ratios" for WCF with those for several U.S. insurance companies. The three leverage ratios used in this study are:

- net written premium-to-surplus;
- net loss and loss adjustment expense reserves-to-surplus; and
- liabilities-to-surplus.

For workers compensation insurers, a large majority of their liabilities is the loss and loss adjustment expense reserve. Therefore, we put more emphasis on the reserves-to-surplus ratio than the liabilities-to-surplus ratio.

By performing this benchmarking study, we are not implying that required surplus or minimum surplus levels can, or should be, determined by looking at rule-of-thumb leverage ratios. However, since these leverage ratios have been so prevalent in the industry, we felt it would be inappropriate to ignore them completely. In addition, the benchmarking study is provided for informational purposes for those who historically have relied upon these leverage ratios.

This benchmarking analysis includes only U.S. insurance companies whose premium is comprised mainly of workers compensation premium. It includes the top writers of workers compensation in many states. In addition, we have separated the comparable insurers into three categories:

- Other State Funds;
- Single Line / Single State Workers Compensation Carriers; and
- Other Insurance Companies.

This separation into categories helps explain differences that may exist due to different lines of businesses written and different types of company structures with varying management return objectives.

Note that for our purposes, we have defined a single line / single state workers compensation insurer as an insurance company which has more than 70% of its total written premium falling within the workers compensation line of insurance in a single state.

Tables 3 through 5 show the comparison of leverage ratios by category. On each exhibit, the comparable insurance companies are listed individually, and at the bottom, an average is calculated by class and compared to WCF's statutory leverage ratios. We also show WCF's restated leverage ratios assuming WCF accrues its loss and loss adjustment expenses reserves at the midpoint of the Actuary's reasonable reserve range and reduces its reserve for tabular discounts. (See discussion under "Multiple of Statutory Surplus Value").

If one were to rely solely on these benchmark leverage ratios, one would arrive at two contradictory conclusions regarding WCF's statutory surplus. First, WCF's premium-to-surplus ratio is lower than the combined benchmark average. Therefore, one could conclude that WCF's statutory surplus is higher than the norm given its position relative to industry benchmarks. On the other hand, WCF's reserve-to-surplus ratio is higher than the combined benchmark average. Therefore, one could also conclude that WCF's statutory surplus is much lower than the industry norm given its position relative to industry benchmarks.

As can be seen, it is difficult to draw a conclusion regarding statutory surplus if one relies upon rule-of-thumb leverage ratios. We believe that the contradictory conclusions arise because each company's risk profile is unique. Companies face a wide range of risks such as underwriting, investment, reinsurance collectibility, catastrophe, and credit risks. Some of these risks are related to insurance while others are not. In addition, the significance of each risk factor varies from insurance company to insurance company. This can be seen by viewing the wide range of leverage ratios by company in the above benchmark study.

Table 3

Other State Funds
Leverage Ratios
Amounts in 000's

Company Name	State	Competitive vs. Monopolistic	Ratios to Surplus: Net Written Premium	Ratios to Surplus: Net Loss & LAE Reserve	Ratios to Surplus: Liabilities	Total Surplus	Percent WC Premium
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
State Comp Fund	Arizona	Competitive	0.503	3.513	2.158	511,841	100%
State Comp Insurance Fund	California	Competitive	3.691	6.788	7.020	1,449,361	100%
Pinnacol Assurance	Colorado	Competitive	2.956	0.661	7.693	107,186	100%
Employers' Mutual Ins. Co.	Hawaii	Competitive	7.871	5.925	11.306	6,050	100%
State Insurance Fund	Idaho	Competitive	1.826	3.136	3.728	68,053	100%
Employers' Mutual Ins. Co.	Kentucky	Competitive	2.107	2.187	3.614	47,868	100%
Workers' Comp. Corporation	Louisiana	Competitive	0.475	0.958	1.543	283,292	100%
Employers' Mutual Ins. Co.	Maine	Competitive	0.843	1.206	1.793	141,179	100%
Injured Workers' Insurance Fund	Maryland	Competitive	2.241	10.493	11.954	72,712	100%
State Fund Mutual Ins. Co.	Minnesota	Competitive	2.220	3.268	4.714	33,931	100%
Employers' Mutual Ins. Co.	Missouri	Competitive	5.906	4.107	6.263	27,090	100%
Mutual Casualty Company	New Mexico	Competitive	0.855	1.225	1.614	54,808	100%
State Insurance Fund	New York	Competitive	1.225	6.202	9.703	1,134,405	100%
Workers' Compensation	North Dakota	Monopolistic	0.229	1.360	1.943	378,632	100%
Bureau of Workers' Comp.	Ohio	Monopolistic	0.354	3.125	4.096	4,516	100%
State Insurance Fund	Oklahoma	Competitive	0.742	0.532	4.115	172,049	100%
SAIF Corporation	Oregon	Competitive	1.146	8.692	10.877	261,796	100%
State Workers' Insurance Fund	Pennsylvania	Competitive	0.941	4.699	5.115	221,240	100%
Beacon Mutual Insurance Co.	Rhode Island	Competitive	1.389	2.460	3.283	97,047	100%
Workers' Comp. Ins. Fund	Texas	Competitive	0.976	1.168	1.808	619,672	100%
Benchmark Combined			1.925	3.585	5.217		
WCF - Booked	Utah	Competitive	0.887	2.497	2.772	219,817	100%
WCF - Adjusted	Utah	Competitive	0.780	2.074	2.315	250,117	100%

Table 4

Single Line/ Single State Workers Compensation Carriers
Leverage Ratios

Amounts in 000's

Company Name	State	Ratios to Surplus: Net Written Premium	Ratios to Surplus: Net Loss & LAE Reserve	Ratios to Surplus: Liabilities	Total Surplus	Percent WC Premium
(1)	(2)	(2)	(3)	(4)	(5)	(6)
Eastern Casualty Ins Co	Massachusetts	0.134	2.217	3.187	45,989	100%
Valor Insurance Co Inc.	Montana	1.238	1.290	1.432	5,345	100%
New Jersey Casualty Ins Co	New Jersey	0.873	1.217	1.741	40,231	100%
Michigan Construction Indstry Mut	Michigan	1.231	1.333	1.841	29,512	100%
Florida Hospitality Mutual Ins	Florida	1.807	3.194	3.861	27,345	100%
Beacon Mutual Ins Co	Rhode Island	1.389	2.460	3.283	97,047	100%
Atlantic Charter Ins Co	Massachusetts	0.662	0.722	1.037	57,077	100%
Associated Industries Ins Co	Florida	2.096	2.435	5.668	36,113	100%
Associated Industries of MA Mut Ins	Massachusetts	1.999	2.009	3.341	50,119	100%
FFVA Mutual Ins Co	Florida	1.578	1.570	2.314	39,001	100%
Key Risk Insurance Co	North Carolina	0.933	0.783	6.171	5,998	100%
Majestic Insurance Co	California	2.142	2.869	3.388	26,399	100%
Amcomp Preferred Ins Co	Florida	2.744	1.905	4.584	42,884	100%
Lackawanna Casualy Co	Pennsylvania	0.663	1.753	2.183	37,914	100%
Accident Fund Co (The)	Michigan	1.007	1.885	2.722	343,949	100%
Builders Insurance	Georgia	1.200	1.214	1.802	60,013	100%
Republic Indemnity of California	California	0.657	1.441	2.265	10,001	99%
Everest National Insurance Co	California	1.302	0.842	5.106	70,005	90%
Rockwood Casualty Ins Co	Pennsylvania	1.088	1.743	2.376	51,345	88%
Alaska Nat'l Insurance Company	Alaska	0.608	1.113	1.495	158,923	78%
Builders Mutual Ins Co	North Carolina	1.123	2.011	2.617	71,743	74%
Association Casualty Ins Co	Texas	0.933	1.560	2.154	17,944	74%
FCCI Mutual Ins Co	Florida	1.213	1.963	2.859	253,221	69%
Service Lloyds Insurance Co	Texas	0.799	1.051	1.926	56,005	59%
Society Insurance	Wisconsin	0.956	1.006	2.191	50,857	57%
Benchmark Combined		1.215	1.663	2.862		
WCF - Booked	Utah	0.887	2.497	2.772	219,817	100%
WCF - Adjusted	Utah	0.780	2.074	2.315	250,117	100%

Table 5

Other Insurance Companies
Leverage Ratios
Amounts in 000's

Company Name	Ratios to Surplus: Net Written Premium	Ratios to Surplus: Net Loss & LAE Reserve	Ratios to Surplus: Liabilities	Total Surplus	Percent WC Premium
(1)	(2)	(3)	(4)	(5)	(6)
California Indemnity Ins Co	1.750	2.561	2.657	90,730	100%
Amguard Insurance Co	2.073	2.429	3.541	29,643	100%
American Compensation Ins Co	2.261	3.371	3.637	26,820	100%
Norguard Insurance Co	1.808	1.986	3.737	33,975	100%
Eagle Pacific Insurance Co	0.432	0.392	1.375	36,754	100%
Fremont Indemnity Group	4.485	7.372	9.085	215,279	100%
Republic Indemnity of America	1.139	2.500	2.382	186,372	99%
Dakota Truck Underwriters	1.952	1.156	1.930	11,138	99%
American Interstate Ins. Co	1.624	1.436	3.121	86,378	99%
Amerisafe Group	1.984	1.770	3.440	86,378	99%
Argonaut Insurance Co	0.450	2.494	2.977	257,960	94%
Zenith Insurance Co	1.651	2.599	3.021	309,810	90%
Capital City Ins Co Inc.	1.444	1.218	1.831	31,096	80%
Pennsylvania Manufacturers Ind Co	1.122	1.253	2.167	57,430	78%
Manufacturers Alliance Ins Co	1.172	1.308	2.322	54,994	78%
Pennsylvania Manufacturers ASN Ins	1.001	1.118	2.163	193,109	78%
Villanova Insurance Co	1.036	1.317	5.265	27,638	70%
Legion Ins Co	0.581	0.925	2.742	298,296	70%
Liberty Northwest Ins Corp	1.032	2.674	3.589	168,594	68%
Companion Property & Casualty Ins Co	1.221	1.160	2.485	68,674	67%
Legion Inurance Group	0.330	0.507	1.741	381,538	58%
Amerisure Ins Co	0.688	2.029	2.812	112,564	53%
Amerisure Mut Ins Co	0.598	1.766	2.807	301,850	53%
Travelers Insurance Group	0.666	2.691	3.881	7,221,540	53%
Benchmark Combined	1.354	2.001	3.113		
WCF - Booked	0.887	2.497	2.772	219,817	100%
WCF - Adjusted	0.780	2.074	2.315	250,117	100%

There are several reasons why WCF's leverage ratios appear low for the premiums-to-surplus ratio and high for the reserves-to-surplus ratio. We list a few of the reasons below.

- WCF began writing workers compensation insurance in the state of Utah in 1917. Workers compensation exposures can take several years to completely payout. On the other hand, most private workers compensation insurers are fairly new entrants into the market compared to WCF. Therefore, WCF has a much larger proportion of open claims than the typical workers compensation insurer.

- WCF has a significant share of permanent disability claims compared to other insurance companies. Permanent disability claims pay out over a much longer time period than temporary or medical-only claims. Therefore, reserves for these claims remain on a company's books for a much longer time than other types of claims.

  WCF has a significant share of permanent disability claims mainly because WCF has a higher market share of hazardous occupations than most workers compensation carriers. We believe that private companies tend to class underwrite and reject certain (e.g., hazardous) types of employers, while WCF is the "insurer of last resort". It is a well-known fact that more hazardous occupations naturally incur more permanent disability claims.

- It has been well documented in the insurance industry literature that the property and casualty insurance industry is under-reserved. Based on the Actuary's analysis of the reserves, WCF's reserves are reasonably stated and fall within a reasonable reserve range. If, in general, the property and casualty industry is under-reserved while WCF's reserves are reasonably stated, WCF's premium-to-surplus and reserve-to-surplus ratios will be different than industry ratios all else being equal.

Another way to benchmark WCF against the industry is to compare its statutory surplus to the NAIC Risk Based Capital (RBC) calculation. Table 6 below shows ratios of statutory surplus to the RBC Company Action Level (CAL) for WCF versus 13 other state funds.

Table 6

Comparison of Surplus to RBC Ratios
Leverage Ratios
Amounts in 000's

Company Name	State	Statutory Surplus	CAL RBC	Surplus to RBC
(1)	(2)	(3)	(4)	(5)
State Compensation Fund of Arizona	Arizona	511,841	192,910	2.7
State Comp. Insurance Fund	California	1,431,400	2,824,989	0.5
Pinnacol Assurance	Colorado	143,700	168,700	0.9
State Insurance Fund	Idaho	68,053	26,399	2.6
Kentucky Employers' Mutual Insurance	Kentucky	47,878	30,418	1.6
Louisiana Workers' Comp. Corp.	Louisiana	283,892	58,279	4.9
Maine Employers' Mutual Ins. Co.	Maine	141,179	36,095	3.9
Minnesota State Fund Mutual Ins. Co.	Minnesota	33,931	16,544	2.1
Missouri Employers' Mutual insurance	Missouri	27,090	26,972	1.0
The New Mexico Mutual Casualty Company	New Mexico	54,808	15,272	3.6
SAIF Corporation	Oregon	261,796	252,993	1.0
Texas Mutual Insurance Company	Texas	619,672	177,731	3.5
The Beacon Mutual Insurance Company	Rhode Island	97,047	43,434	2.2
Benchmark Combined				2.3
WCF - Booked	Utah	219,817	86,014	2.6
WCF - Adjusted	Utah	250,117	86,014	2.9

From this table, it appears that WCF's statutory surplus is as adequate, if not more adequate, than many other state funds. We remind the reader that this is just a benchmark, and it is difficult to draw conclusions simply by looking only at these ratios. As mentioned previously, companies are subject to a wide range of different risks that may lead to differences in apparent surplus adequacies.

Phase 2 – Surplus Model

To provide a more in-depth analysis, we developed a surplus model to help quantify the volatility in WCF's reserves and future premium writings. To simplify the analysis, we separate our review of WCF's statutory surplus into two separate and individual "Risks".

- "Risk 1": the risk related to the run-off of the loss and loss adjustment expense reserves as of December 31, 2002. The reserves are on an undiscounted basis or statutory basis. The question that we attempt to answer is: "How much surplus is indicated to support these reserves as of December 31, 2002"?

- "Risk 2": the risk related to writing new premiums in the coming year. Again, the question that we attempt to answer is: "How much surplus is indicated to support the future premium writings in the upcoming year"?

Risk 1 – Volatility of the Loss and Loss Adjustment Expense Reserve

Required surplus has usually been thought of as a function of volatility. The more volatile the reserves and investment returns, the more surplus is required. Therefore, the question of how much statutory surplus is required to support the loss reserves is a function of the volatility of the loss reserves and the investment returns.

We note that the statutory loss reserves in Utah are required to be stated on an undiscounted basis, except for a minor amount of tabular discount on indemnity claims that have reached a final pension or annuity status. Therefore, the time value of money is not reflected in statutory loss reserves for the majority of claims.

The amount of volatility or uncertainty in workers compensation undiscounted loss reserves is quite large primarily due to the long tail nature of workers compensation claims and the unknown and highly variable effect of monetary inflation (particularly medical inflation). Estimating workers compensation medical inflation has become increasingly difficult in recent years. For example:

- Over the past 30 years, workers compensation medical trend has averaged 8% to 9% annually.
- In the early to mid 1990's, workers compensation medical trend averaged 3% to 5% annually.
- Medical inflation is currently being projected by economists and health care professionals to be as high as 14% in 2003.
- While long term historical averages would point towards future medical inflation of 8% to 9%, some economists and health care professionals suggest that it is more likely that future legislation and reform will decrease medical inflation (e.g. 4% to 5%) to maintain the stability of the economy.
- On the other hand, others suggest that long term medical inflation will continue to be 8% to 9% and overall general inflation will increase to compensate for medical costs becoming a larger and larger portion of the gross national product.

Because of the uncertainty surrounding future medical inflation, there is an increased volatility associated with medical loss reserves.

We used our surplus model to help quantify the variability of the statutory reserves as of December 31, 2002. In simple terms, the surplus model stochastically simulates the loss reserves as of December 31, 2002 and future investment returns by varying the key risk factors faced by WCF. Each simulation represents a unique outcome of WCF's future results (For a complete description of the model and its assumptions, please refer to **Appendix B**).

To model the variability, the model is run 5,000 times, which represents 5,000 possible scenarios for the statutory loss reserves as December 31, 2002 (e.g., 5,000 different medical inflation scenarios, interest rates, etc.). Table 7 below shows the aggregate results of the simulations. The average, standard deviation, 5th percentile, and 95th percentile are shown to illustrate the volatility in the statutory loss reserves that result from the surplus model. The table also shows WCF's reported statutory reserves and the actuary's reasonable reserve range from its independent reserve analysis.

Table 7

Variability of Statutory Loss Missions ($ Million)
WCF Reserves as of December 31, 2002

	5,000 Sims Surplus Model	WCF Booked		Actuarial Low	Actuarial Midpoint	Actuarial High
Median	$520		$549	$504	$535	$565
Average	535	Tab. Discount:		(16)	(16)	(16)
Standard Deviation	81	Adj. Stat. Res:		488	519	549
5th Percentile	437					
95th Percentile	682					

WCF's recorded statutory surplus as of December 31, 2002 totaled $220 million. Under most loss probability distributions, there is a reasonable chance that losses may develop by one standard deviation or more. The above table indicates that if the actual future payouts of loss and loss adjustment expenses do turn out to be one standard deviation higher than the average (i.e., 15% adverse development), WCF's statutory surplus would be nearly reduced by 37%.

Risk 2 – Surplus Required to Support Future Writings

The surplus model treats "Risk 2" as a startup company. The startup company will be expected to write a certain amount of workers compensation premium in the coming year. The amount of surplus required to support the new company depends heavily on the uncertainty or variability surrounding the underwriting results of the future premium exposure and the potential investment income related to these premiums.

Future underwriting operations can have a significant amount of variability due to several factors, including:

- Regulatory constraints on the pricing and marketing of workers compensation;
- Judicial and legislative decisions that can significantly alter expected losses;
- Competition;
- Mix of business;
- Catastrophic risk;
- New classes of occupational disease; and
- Medical Inflation.

Summary

The surplus model is described in more detail in **Appendix B**. The surplus model runs 5,000 simulations of WCF's statutory results as of December 31, 2002 and for a future calendar year (i.e., 2003). Each simulation represents a potential outcome of the statutory surplus as of December 31, 2002 and December 31, 2003. The simulated statutory surplus for a given year depends upon the projection of the assumptions in the model (e.g. medical inflation, loss severity, investment returns, etc.).

Table 8 below displays the results of the 5,000 simulations under different minimum surplus requirements. In order to estimate a required level of surplus, one must choose both an appropriate minimum level of surplus and a probability requirement for that surplus to remain above that minimum level target. For example, suppose that a reader believes an appropriate minimum level of surplus is the RBC Company Action Level and that he or she wants statutory surplus set such that 99% of the time it remains above the RBC Company Action Level, then according to Table 8 the required statutory surplus would be $206 million.

Since WCF's current statutory surplus adjusted to the Actuary's reserve mid-point and reduced for tabular discounts is $250 million, then under the above constraints, a total of $44 million excess statutory surplus is indicated.

Table 8

Surplus Model Results -- 5,000 Simulations
Required Statutory Surplus Levels

	Probability of Remaining Above Minimum Surplus Requirement				
Minimum Surplus Requirements	99.5% Ratio	99.0% Ratio	98.0% Ratio	96.5% Ratio	95.0% Ratio
	Required Statutory Surplus ($ Millions)				
2.0 x RBC CAL	$472	$418	$362	$316	$288
1.5 x RBC CAL	370	309	257	212	183
RBC CAL	268	206	152	107	105
RBC RAL	213	153	99	78	78
RBC ACL	163	99	52	52	52
RBC MCL	105	52	26	26	26
	Excess Statutory Surplus ($ Millions) *				
2.0 x RBC CAL	($222)	($168)	($112)	($66)	($38)
1.5 x RBC CAL	(120)	(59)	(7)	38	67
RBC CAL	(18)	44	98	143	145
RBC RAL	37	97	151	172	172
RBC ACL	87	151	198	198	198
RBC MCL	145	198	224	224	224

* From Actuary's mid-point, including tabular discounts.

This concept of value is probably most applicable when questions of how much surplus is required to operate as a regulated insurance company are considered. For example, this approach to value might be appropriate for determining the statutory surplus for a governmental or quasi-governmental agency insurance company or a mutual insurance company. Excess Statutory surplus could be provided to its owners in the form of a dividend. On the other hand, this concept of value may not be appropriate to value a company in preparation for a transaction (sell) or a demutualization.

Value Concept 4: Discounted Statutory Surplus Value

Definition

Up to this point in our discussion, we have focused on statutory or GAAP surplus. As we have mentioned previously, loss reserves under both statutory and GAAP accounting are stated on an undiscounted basis. Therefore, these reserves do not recognize the time value of money. Because statutory (and GAAP) reserves are not allowed to recognize the time value of money, there may be a certain amount of equity that is not recognized. The discounted statutory surplus value attempts to partially recognize this equity.

Analysis

The discounted statutory surplus value partially recognizes the implicit (because of regulation) equity in GAAP and statutory accounting by conservatively discounting the loss reserves.

It must be understood that the State of Utah currently requires property and casualty insurance companies to record losses on an undiscounted basis. To discount the loss reserves and show surplus on a discounted basis would require a permitted practice from the Utah Department of Insurance. However, we note that providing such a permitted practice to discount loss reserves would not be unique. Other states currently allow, to varying degrees, their State Funds to discount loss reserves. For example, the following State Funds discount their loss reserves beyond what is allowed under the NAIC codification rules and have permitted practices to do so from the insurance departments of their respective states of domicile.

- Arizona: Discounts All Indemnity Reserves (not the medical reserves)
- Idaho: Discounts All Indemnity Reserves (not the medical reserves)
- Maryland: Discounts All Indemnity Reserves (not the medical reserves)
- Minnesota: Discounts All Indemnity & Medical Reserves
- Nevada: Discounts All Indemnity & Medical Reserves (Prior to 95)

We have used certain assumptions in the Actuary's reserve study to estimate the loss reserve's future payment streams as of December 31, 2002. Table 9 below provides a summary of the estimated discounted loss reserves after applying different degrees of discounting to the Actuary's low, mid-point, and high. The table also shows the implied re-stated surplus if that level of discounting were allowed. Discounting was performed assuming an interest rate of 3.5% annually.

Table 9

Estimated Discounted Statutory Surplus Value
($ Millions)

	WCF Booked	Actuarial Low	Actuarial Midpoint	Actuarial High
Undiscounted Reserves	$549	$504	$535	$565
Discounted Reserves				
Tabular Disounts Only (Statutory)	533	488	519	549
Discounting Indemnity Only	514	472	501	529
Discounting Indemnity & Medical	394	362	383	405
Undiscounted Surplus	$220	$265	$234	$204
Discounted Statutory Surplus				
Tabular Disounts Only (Statutory)	236	281	250	220
Discounting Indemnity Only	255	297	268	240
Discounting Indemnity & Medical	375	407	385	364

Summary

The discounted statutory surplus value recognizes the equity in statutory and GAAP reserves due to the time value of money. This concept of value is useful only under certain situations and always requires a permitted practice from the insurance department to discount the statutory reserves.

In the past, certain insurers have attempted to recognize the time value of money by completing a reinsurance transaction or a loss portfolio transfer of the outstanding loss reserves. To the extent that a reinsurer was willing to accept the reserve risk at a lower value than what was recorded on the insurer's financial statements on an undiscounted basis, the insurer was able to recognize some of the equity in the statutory reserves without insurance department approval.

This type of transaction, if performed today, would also require a permitted practice to recognize the time value of money in the transaction. Statutory accounting has changed the way reinsurance transactions are recorded on financial statements and, as such, the value of these contracts may not be readily apparent on an insurer's surplus. On the other hand, if a favorable reinsurance transaction could be made and a permitted practice to discount loss reserve is granted, then monies may be available to the owners without materially changing the reported surplus.

The State of Nevada is a unique case. Prior to July 1, 1999, Nevada was a monopolistic state; all workers compensation insurance was written through its State Fund, State Industrial Insurance System (SIIS). On July 1, 1999, SIIS was renamed Employers Insurance Company of Nevada (EICN) and converted to a competitive state fund. Private insurers were allowed to sell workers compensation insurance in Nevada. On January 1, 2000, EICN was then privatized into a mutual insurance company, its current status now. In late 1999, when EICN went through its privatization, it had a potentially large statutory reserve deficit for which the State risked having to bear. As part of the privatization, EICN purchased a reinsurance policy (loss portfolio transfer), and a significant portion of its reserve liabilities were transferred to the reinsurer at a significantly lower value than what was stated on its financial statements. EICN was then granted a permitted practice by the insurance department to discount the transferred loss reserve in order to show the benefit of the transaction. The result was the complete removal of the statutory deficit.

Value Concept 5: Economic Value

Definition

Economic value is also referred to as the "actuarial appraisal value". It is a common actuarial method of valuing an insurance company. It represents the discounted present value of the free cash flows generated by the current book of business (i.e., future earnings greater than the estimated amount needed in the respective fiscal period to maintain surplus at a targeted level). The cash flows are based on the actuarial projections of cash flows generated by the insurance products and investment returns over a period of time (e.g., 10 to 20 years) or the life of the book of business. The discount rate reflects the time value of money. The cash flows are typically discounted using different interest rates, which provide a range of values based on different opportunity cost of capital ("OCC") assumptions.

Economic value does not specifically value goodwill of an insurance company (although one could argue that goodwill is inherent in the profitability of the business). Consequently, economic value is most applicable to valuing an existing book of business. Thus, economic value is often thought of as a "floor value" and is often the initial step in a "fair value" opinion.

Analysis

We have built a discounted cash flow model to provide the State with the economic value under two different scenarios (or alternative structures). The two scenarios are:

1. Mutualize into an Independent Mutual Insurance Company (with no restrictions); and
2. Demutualize into an Independent Stock Company.

Under both scenarios, WCF will be a tax-paying entity and will not act as the carrier of last resort. We have considered only these two structures under this value concept because we believe the concept is only relevant / applicable to these structures.

The detailed assumptions for the two separate alternative structures are attached to this document as **Appendices C and D**, respectively. Most of these assumptions have been provided to us by WCF management. Appendices C and D also contain the pro-forma financial statement projections for each structure.

In order to estimate the "free cash flows" (or the "investment returns" to the owners) a constraint or a level of required surplus needs to be chosen. Many times leverage ratios (either premium or liabilities) to surplus are used to calculate the required level of surplus and any excess surplus becomes the "free cash flows" to the investors. Because of the issues with leverage ratios (as discussed in the section on "Excess Statutory Value"), we have chosen a constraint as a multiple of RBC Company Action Level. Therefore, at the end of each year any statutory surplus in excess of the required surplus becomes free cash flow. These free cash flows are discounted to December 31, 2003.

Summary

Table 10 below is a summary of the economic value analysis that we have performed for both alternative scenarios. The "free cash flows" are discounted to December 31, 2003. The economic value as of December 31, 2003 is shown for interest rates of 10%, 12%, 15%, and 17% and under three different constraints (1.5, 2.0 and 2.5 times RBC CAL).

Table 10

Economic Value ($ Millions)
Scenario 1: Independent Mutual Company (w/ No Restrictions)

Selected Constraint	Cost of Capital or Discount Rate			
	10% Ratio	12% Ratio	15% Ratio	17% Ratio
2.5 x RBC CAL	$285	$260	$229	$212
2.0 x RBC CAL	304	282	256	241
1.5 x RBC CAL	321	304	282	270

Economic Value ($ Millions)
Scenario 2: Independent Stock Company

Selected Constraint	Cost of Capital or Discount Rate			
	10% Ratio	12% Ratio	15% Ratio	17% Ratio
2.5 x RBC CAL	$316	$280	$236	$212
2.0 x RBC CAL	338	306	268	247
1.5 x RBC CAL	359	333	300	282

Value Concept 6: Fair Market Value

Definition

Fair Value is the professional opinion of a financial advisor (typically, an investment banker) of the fairness of the transaction price from a financial perspective. It takes into account current market conditions, the regulatory environment, the political environment, recent transactions, company projections, the form of the transaction and other items. It is an opinion whether the considerations are "fair" in the current environment.

The financial advisor will often use several approaches and metrics in developing its fairness opinion, including discounted cash flow models and recent comparable transactions expressed as multiples of book value, earnings and premiums. The use of comparable transactions is most relevant in a strong insurance merger and acquisition market where there are many comparable transactions to use as metrics. In a weak insurance merger and acquisition market, as has existed during the past several years, it is often difficult to find relevant comparable transactions.

Discussion on value of historical Federal Tax Exemption

As part of our analysis of value, we were asked to review and comment on the historical tax exempt status of WCF and the impact, if any, on surplus.

As will be discussed in more detail in Section VII ("Federal Tax Implications"), WCF has held its Federal tax exempt status mainly because it has been the insurer of last resort in the state of Utah. This means that WCF has provided insurance to employers that typically would be part of the residual market (see Section IV for a definition of the residual market). Therefore, a discussion regarding the value of the Federal tax exempt status must also consider the fact that the WCF has insured the residual market.

Since WCF is the insurer of last resort, WCF has provided insurance to certain policyholders that it would otherwise not (i.e. the residual market employers). These employers are usually the most risky employers. The premiums charged to these policyholders are not usually adequate (and have not been adequate) to cover the losses and expenses associated with writing the policies. Therefore, the value of Federal tax exemption is diminished since operating losses are associated with these polices. In fact, it could be possible that operating losses from the residual market risks completely overcome any other operating profits. In this scenario there is no value to the Federal tax exemption since the Company overall experiences an operating loss and is not subject to Federal tax anyway.

In addition, the value of the Federal tax exemption really depends upon how the business is actually managed. For example, the WCF has really managed its business over the past several years on a break even basis. Therefore, WCF has not taken advantage of any Federal tax exemption that it has had over the past five years.

Another complication in trying to estimate the value of the Federal tax exemption is that tax-exempt and taxable entities operate differently. For example, WCF has mainly invested in taxable bonds. As a taxable entity, WCF would have invested more in tax-exempt bonds. In addition, pricing policy, underwriting policy, policyholder dividend policy would have all been different if WCF was a taxable entity versus a tax-exempt entity.

Therefore, it is not possible to quantify the value of the historical Federal tax exemption and we do not believe the value would be that material if it could be quantified.

VI. Alternative Organizational Structures

The Current WCF Company Structure and Alternatives

There are several possible organizational structures for WCF that may interest the State of Utah. Based on our discussions with WCF management, the Governor's Office, and the Utah DOI and on our experience in the industry, we have developed the following list for consideration:

- *Status Quo* – WCF will continue to operate in its current form, as a quasi-governmental tax-exempt entity and as the carrier of last resort in the State of Utah.

- *Revert to State Agency* / Core Mission – The State of Utah would re-assert its control / ownership over WCF, and WCF would once again become a government controlled state agency. WCF would remain the sole residual market insurer of last resort in the State of Utah

- *Mutualize into an Independent Mutual Insurance Company But Maintain Status as Carrier of Last Resort* – Under this alternative, the State of Utah would relinquish all control and formalize WCF as a fully independent mutual insurance company. However, WCF would remain, through contract, the sole residual market insurer of last resort in the State of Utah and thus a tax-exempt entity. As a mutual insurance company, WCF would be owned by its policyholders. The policyholders would manage the company through a policyholder elected board of directors and could receive policyholder dividends.

- *Mutualize into an Independent Mutual Insurance Company (No restrictions)* – Similar to above, but the State of Utah would NOT enter into a contract with WCF to be the sole residual market insurer. The State would implement an alternative residual market solution. Thus, WCF would lose its tax-exempt status.

- *Demutualize into an Independent Stock Company* – Under this alternative, the State of Utah would pass legislation allowing for the demutualization of WCF. Through the demutualization process, WCF would be converted from a mutual insurance company owned by its policyholders to a stock insurance company owned by its stockholders. The policyholders would exchange their policyholder rights for cash or stock in the new company. As a stock insurance company, WCF would be owned by its stockholders. The stockholders would manage the company through a stockholders' elected board of directors and would be entitled to stock dividends.

- *Sell WCF* – The risks and implications would be the same under this alternative as they would be under the *"Demutualize into an Independent Stock Company"* discussed above.

Hybrid Structures - Various hybrid structures (variations or combinations of the above) are also possible, depending on the goals and objectives of the various parties to the transaction. We have presented an example of a hybrid structure below.

During our conversations with the various parties, a common theme emerged: an overriding concern for the policyholders and impact on the workers compensation residual market in Utah. In addition, we know that the impact on WCF is important, as are state interests. Thus we have focused our analysis in these areas. It should be noted that Utah currently has the second lowest workers compensation premiums in the nation, which indicates that the current structure is working effectively. Thus, we have included status quo and a reversion to a state agency as viable alternatives.

Several of the alternatives would require the implementation of a residual market alternative, which we have highlighted in the policyholder availability / residual market section. The residual market alternatives are discussed in more detail in Section IV of the report. In general, any alternative to the current residual market structure is likely to result in increased premiums to the residual market policyholders in the short term.

Each structure has its own risks and opportunities that should be carefully considered in the decision making process. It should also be noted that there are potential variations of each structure that could be developed to mitigate issues or complexities in implementation. For example, potential complexities associated with demutualizing into a fully independent stock company can be reduced by a phased approach over a period of several years.

We have noted risks and opportunities with respect to the structural alternatives on the operations, management and employees of WCF. The conversion of WCF to a fully independent mutual insurance company or stock company would be expected to result in changes in business strategy, focus, culture, capital requirements, pricing, profitability and other areas. We have noted some of the major considerations in the pros and cons, but this is not meant to be all-inclusive. We have not spent sufficient time with WCF management or analyzing WCF's operations to fully understand the issues WCF would face in the scenarios. This was beyond the scope of the engagement.

Lastly, we have also considered the impact of alternatives on State and policyholders' interests, which we call "value". We understand WCF has proposed a $50 million payment to the State of Utah for relinquishing the State's controlling interest. The amount of the payment could also vary by structural alternative, and we understand the State has hired an investment banker to assist in understanding the valuation aspects of the various alternatives. Consequently, we have noted where potential valuation issues differences exist but refer, and defer, to the investment banker's opinion.

There are also various regulatory and implementation implications associated with the alternatives that must be addressed. The current quasi-government agency status presents various legal hurdles and opportunities, many of which can be impacted by legislative action. Thus, we have not disregarded any alternatives based on potential regulatory or implementation issues.

Certain alternatives, such as the conversion to a fully independent mutual or stock company, would result in the loss of the WCF's tax-exempt status. Thus, the Federal government would no longer be "subsidizing" the workers compensation residual market in Utah. In addition, the loss of tax exempt status may increase WCF's expense structure and, in the short term, could result in higher workers compensation premiums to certain segments of the market. However, the loss of tax-exempt status would also place WCF on equal footing with the rest of the workers compensation insurance industry, which would likely bring new insurers into the Utah market and foster a new era of competition. Over the long term, increased competition would be expected to result in lower workers compensation premiums.

The risks and opportunities are heavily dependent on the capability of WCF management to execute a given strategy, the economic and workers compensation environment, and the extent to which the selected strategy is appropriately supported by legislation to implement the strategy. Success and failure have been observed at both ends of the spectrum of possibilities. We have seen state funds with $2 billion deficits, and we have seen large national stock carriers go insolvent. On the other hand, some state funds, such as Utah's, have served their policyholders well for almost a century. Some small regional stock carriers have emerged as successful national carriers. In addition, if a stock organization is pursued, consideration should be given to the financial market, particularly with respect to timing of any offering and the ability to get capital desired from such offering.

In the case of the WCF, management has a proven track record of success, supported by a workers compensation system with a reasonable balance between benefits and premiums. The selection of a specific alternative by the State depends on the State's priority for policyholders, the WCF and the State itself, as well as on the State's assessment of the likelihood of the respective risks and opportunities.

Alternative Organizational Structure #1

Reversion to a Government Controlled State Agency

Stakeholder: 1. Policyholder

Issue	Risk	Opportunity	State Priority
▪ Availability / Residual Market	*1a)* A State Agency might not be subject to same pricing discipline. Could quickly add policyholders, build a deficit, and cause a subsequent market dislocation. Possible adverse selection and over-subsidization of unprofitable policyholder groups.	*1b)* If pricing discipline is maintained, a reasonably competitive environment with more carriers could emerge. An agency could provide a high assurance of availability.	
▪ Affordability	*2a)* Insurance industry may have to fill in gaps left by potential inability of a state agency to serve policyholders. (see *1a*).	*2b)* Limited opportunity to increase affordability, but state control could mandate premium levels.	
▪ Quality Service	*3a)* State budgeting and oversight process may limit an agency's ability to invest in service, control losses, settle claims efficiently, and hire talented and skilled personnel. Limited or no ability to serve policyholder needs outside Utah (which may limit ability to serve Utah employers).	*3b)* Limited opportunity for agency to positively impact marketplace. Insurance industry may fill in gaps.	
▪ Value	*4a)* Policyholders may claim their assets are being taken by the State without due course.		

Alternative Organizational Structure #1

Reversion to a Government Controlled State Agency

Stakeholder: 2. WCF			
Issue	Risk	Opportunity	State Priority
▪ Operations	*5a)* Market limited to smaller employers with business solely in Utah. Agency is focused on State budget allocation vs. profit. Limited growth potential unless the Agency doesn't maintain pricing discipline (see *1a*). Possible loss of management talent could lead to *1a*.	*5b)* Specialization helps control costs of smaller employers and/or residual market. Limited or no opportunity for profit and capital accumulation. Limited growth potential.	
▪ Federal Tax	*6a*) Exemption maintained.	*6b)* Exemption maintained.	
▪ Viability / Capital Requirements	*7a*) Possibly adverse (see *1a*). Also subject to concentration of risk. State Agency loses Guaranty Fund coverage.	*7b*) State backing could assure viability.	

Alternative Organizational Structure #1

Reversion to a Government Controlled State Agency

Stakeholder: 3. State			
Issue	Risk	Opportunity	State Priority
▪ Regulatory / Implementation	*8a)* Probably no longer subject to Insurance Department Regulation. Reintegrating to a State Agency could be difficult. Limits future alternatives.	*8b)* Limited upside. Possible specification (see *5b*).	
▪ Economic Impact	*9a)* State has liability.	*9b)* Limited upside.	
▪ Value	*10a)* Opportunity to realize value to the State is limited. State liability increases, budget needs increase. Attempts to gain use of the assets of value may be subject to dispute.	*10b)* Limited value.	

Alternative Organizational Structure #2

Status Quo

Stakeholder: 1. Policyholder			
Issue	**Risk**	**Opportunity**	**State Priority**
▪ Availability / Residual Market	*1a)* Insurance industry might fill in gap as WCF becomes less able to serve Utah employees with out-of-state operations (and multi-state employers elect to non-renew WCF coverage). Non-Residual Market policyholders may subsidize residual market policyholders. Competition in Utah restricted with WCF tax exemption as a pricing advantage.	*1b)* Availability could remain good. Residual market availability assured.	
▪ Affordability	*2a)* Potential higher premiums as WCF loses spread of risk due to *1a*. Carriers who fill in gap don't have Federal tax exemption.	*2b)* Impact of WCF's market limitations on premiums is spread over years. Increased competition may control premiums.	
▪ Quality Service	*3a)* Some risk for deterioration over time as WCF's ability to cover employers is limited.	*3b)* Limited risk for deterioration if industry fills the gap.	
▪ Value	*4a)* Possible continued questions on who owns the value. Value could diminish over time.	*4b)* Limited upside in value accumulation. WCF could still pay policyholder dividends.	

Alternative Organizational Structure #2

Status Quo

Stakeholder: 2. WCF			
Issue	**Risk**	**Opportunity**	**State Priority**
▪ Operations	*5a)* WCF market focus narrows somewhat as other states' statutes limit WCF's ability to compete. Profit/growth may be somewhat limited as insurance industry could take business with operations outside of Utah. Service innovation may be limited.	5*b)* In a limited market, WCF continues to provide quality coverage and unbundled services. WCF continues to have a competitive pricing advantage due to Federal tax exemptions. Pays dividends to policyholders. Profit contribution to capital is not a major focus.	
▪ Federal Tax	*6a)* Exemption retained, limiting competition in the State.	*6b)* Exemption retained with favorable impact on policyholder availability and affordability.	
▪ Viability / Capital Requirements	*7a)* Subject to typical industry pressures plus concentration of risk. Capital can only be internally generated.	*7b)* Conservatism in statutory balance sheet and A- Best rating is a good indication of operational and financial strength. Guaranty Fund status maintained.	

Alternative Organizational Structure #2

Status Quo

Stakeholder: 3. State			
Issue	**Risk**	**Opportunity**	**State Priority**
▪ Regulatory / Implementation	*8a*) Minimal impact, if any. Department of Insurance continues regulation of a quasi-public agency with governor's appointment of 5 Board members.	*8b)* Minimal impact, if any. Department of Insurance continues regulation of a quasi-public agency with governor's appointment of 5 Board members.	
▪ Economic Impact	*9a*) Impact of a potentially significant Utah based carrier is diminished.	*9b*) State retains a significant carrier.	
▪ Value	*10a)* Not realized at this time except for potential policyholder dividends.	*10b*) State could retain options for the future.	

Alternative Organizational Structure #3

Independent Mutual Insurance Company Carrier of Last Resort (CLR)

Stakeholder: 1. Policyholder

Issue	Risk	Opportunity	State Priority
▪ Availability / Residual Market	*1a)* Non-residual market policyholders may continue to subsidize residual market policyholders. Competition in Utah restricted with WCF tax exemption as a pricing advantage.	*1b)* Availability could remain good and possibly improved with WCF ability to provide out-of-state coverage.	
▪ Affordability	*2a*) WCF expansion to other states may be unprofitable. Potential loss of tax exemption could have an adverse impact on premiums.	*2b)* Affordability may be favorably impacted by profitable WCF expansion with tax exemption retained.	
▪ Quality Service	*3a*) Balancing multi-state growth with service capacity could be a challenge.	*3b*) Controlled growth in profitable business could be matched with quality service.	
▪ Value	*4a*) Policyholders may concede some value to confirm ownership.	*4b*) Policyholders may concede some value to confirm ownership and have potential for increased value over time. WCF could still pay policyholder dividends.	

Alternative Organizational Structure #3

Independent Mutual Insurance Company, Maintain Carrier of Last Resort (CLR)

Stakeholder: 2. WCF			
Issue	**Risk**	**Opportunity**	**State Priority**
▪ Operations	*5a)* WCF may have difficulty in claiming its niche in a multi-state market. Profit could deteriorate as a result of over expansion or expansion to unprofitable markets. Better growth potential than status quo, but growth is limited by what can be realized from internally generated capital, which could be eroded by deteriorating results. Service capability could be limited or deteriorate with weak operations.	*5b)* Few changes implemented as WCF strategy contemplates operating as a mutual insurer. Through a disciplined market focus, WCF could claim its market niche in profitable out-of-state operations. WCF's focus on long-term profit could produce solid results over time funded by current capital. Emerging with a solid base of capital and disciplined market focus, growth potential (size, scale, dispersion of risk) is good, but still limited by internally generated capital.	
▪ Federal Tax	*6a)* Growth could result in loss of tax exemption – causing need to quickly implement a new residual market mechanism.	*6b)* Tax exemption could be maintained if core in-state operations are dominant.	
▪ Viability / Capital Requirements	*7a)* Subject to typical industry pressure plus concentration of risk. Potential operational weakness poses concern. Capital can only be internally generated.	*7b)* Potential is for limited adverse impact due to A-Best rating which is an indication of solid operational and financial strength. Mgmt believes surplus could be adequate after a payment to State to resolve organizational status. Operational strength may enhance viability, even with concentration of risk. Guaranty fund status maintained.	

Alternative Organizational Structure #3

Independent Mutual Insurance Company, Maintain Carrier of Last Resort (CLR)

Stakeholder: 3. State			
Issue	**Risk**	**Opportunity**	**State Priority**
▪ Regulatory / Implementation	*8a)* Legislation to confirm organizational structure could be complex. State would have limited future options and alternatives unless these are conditions and/or restrictions as a condition of mutualizing. As a result of a new organizational structure, a Form A filing would be required for approval by the Utah Insurance Department.	*8b*) State clarifies and simplifies WCF regulatory status as subject to the Department of Insurance.	
▪ Economic Impact	*9a*) May be limited as a mutual; especially with *5a* and *6a*.	*9b*) WCF's continued expansion would have a favorable impact on the economic environment.	
▪ Value	*10a)* Realizing State's value.	*10b*) Current value to State a function of "control premium", "litigation risk premium" and "good will premium". Individual (including State) policyholder value maintained including policyholder dividends, but may not increase, because overall value increase is offset by more policyholders.	

Alternative Organizational Structure #4

Independent Mutual Insurance Company, Lose Status as Carrier of Last Resort (CLR) and Tax Exemption

Stakeholder: 1. Policyholder

Issue	Risk	Opportunity	State Priority
▪ Availability / Residual Market	*1a)* State would have to implement a residual market alternative. A formally recognized "residual market" would exist as WCF non-renewed policyholders it would not write voluntarily.	*1b)* The NCCI, for example, has successfully implemented residual market services in many states.	
▪ Affordability	*2a)* Residual market and minimum premium policyholders may be subject to premium increases due to the loss of WCF's tax exemption and conversion to new premium rating system. An accelerated timing of residual market implementation could increase costs. The changes would impact the voluntary market to a lesser extent.	*2b)* Voluntary market could benefit to some extent as previous residual market subsidiaries are diminished.	
▪ Quality Service	*3a)* A new servicing carrier and a new residual market structure could impact service to that segment. WCF resources may be diverted temporarily from voluntary market focus.	*3b)* If sufficient lead time is allowed, the transition to a residual market can be smooth.	
▪ Value	*4a)* Policyholders may concede some value to confirm ownership. Over time, value goes to remaining (non-residual market) policyholders.	*4b)* Policyholders may concede some value to confirm ownership and potential increased value over time. WCF could still pay policyholder dividends.	

Alternative Organizational Structure #4

Independent Mutual Insurance Company, Lose Status as Carrier of Last Resort (CLR) and Tax Exemption

Stakeholder: 2. WCF

Issue	**Risk**	**Opportunity**	**State Priority**
▪ Operations	*5a)* WCF may have difficulty in claiming its niche in a multi-state market. Loss of tax exemption may reduce profits, change underwriting strategy, and increase premiums for their voluntary business. Profit may deteriorate as a result of expansion or over expansion to unprofitable markets. Better growth opportunity than status quo, but growth is limited by what can be realized from internally generated capital. Service capability could be limited or deteriorate with weak operations.	*5b)* WCF may have to somewhat adjust their operations if they were no longer the CLR. Ceding its most unprofitable business to the residual market may improve its results, more than offsetting the loss of the tax exemption. WCF's mutual insurance focus on long-term profit could produce solid results over time, funded by current capital. Thus, WCF's growth and profit potential could remain strong, along with their ability to provide quality service.	
▪ Federal Tax	*6a)* WCF loses tax exempt status. Investment portfolio may have to be restructured to reflect tax status.	*6b)* Competition in Utah would increase as WCF would no longer have the tax exemption as a competitive pricing advantage.	
▪ Viability / Capital Requirements	*7a)* Subject to typical industry pressure plus concentration of risk. Potential pressure due to operations and loss of tax exemption. Capital can only be generated internally.	*7b)* Potential is for limited adverse impact due to A-Best rating, which is an indication of solid operational and financial strength. Management believes surplus could be adequate after a payment to the State to resolve organizational status. Thus, WCF's growth and profit potential could remain strong, along with their ability to provide quality service. Guaranty fund status maintained. Diversification could increase spread of risk.	

Alternative Organizational Structure #4

Independent Mutual Insurance Company, Lose Status as Carrier of Last Resort (CLR) and Tax Exemption

Stakeholder: 3. State			
Issue	**Risk**	**Opportunity**	**State Priority**
▪ Regulatory / Implementation	*8a)* Legislation to confirm organizational status may be complex. State may have limited future options and alternatives unless there are conditions and / or restrictions as a condition of mutualization. As a result of a new organizational structure, a Form A filing would be required for approval by the Utah Insurance Department.	*8b)* State can clarify and simplify WCF's regulatory status as subject to the Department of Insurance.	
▪ Economic Impact	*9a)* Economic impact may be limited as a mutual, especially with *5a*.	*9b)* WCF's continued expansion may have a favorable impact on the economic environment.	
▪ Value	*10a)* Realizing State's value.	*10b)* Current value is a function of "control premium", "litigation risk premium" and "goodwill premium". Individual (including State) policyholder value maintained including policyholder dividends, but may not increase, because overall value increase is offset by more policyholders.	

Alternative Organizational Structure #5

Demutualize into Independent Stock Insurance Company No Carrier of Last Resort (CLR), No Tax-Exemption

Stakeholder: 1. Policyholder

Issue	Risk	Opportunity	State Priority
▪ Availability/Residual Market	*1a)* State will have to implement a residual market alternative. A formally recognized "residual market" would exist as WCF non-renews those policyholders it does not want to write voluntarily.	*1b)* The NCCI, for examp le, has successfully implemented residual market services in many states.	
▪ Affordability	*2a)* Residual market and minimum premium policyholders will be subject to premium increases due to the loss of WCF's tax exemption and conversion to a new premium rating system. An accelerated timing of residual market implementation could increase costs. The changes could also impact the voluntary market as WCF responded to shareholder return expectations.	*2b)* Voluntary market could benefit to some extent as previous residual market subsidiaries are diminished.	
▪ Quality Service	*3a)* A new servicing carrier and residual market structure could impact service to that segment. WCF resources may be diverted temporarily from voluntary market focus.	*3b)* If sufficient lead time is allowed, the transition to a residual market can be smooth.	
▪ Value	*4a)* Policyholders may concede some value to confirm ownership, and be subject to tax. Over time, value goes to remaining (non-residual market) policyholders. The timing may not be good to form a stock company.	*4b)* Policyholders may concede some value to confirm ownership and potential increased value to policyholders/stockholders over time. Valuation of WCF could likely be higher as a stock thus increasing policyholder value. Depending on the form of the demutualization transaction, the policyholders could get cash or become stockholders in WCF and have the potential for dividends and capital appreciation.	

Alternative Organizational Structure #5

Demutualize into Independent Stock Insurance Company No Carrier of Last Resort (CLR), No Tax-Exemption

Stakeholder: 2. WCF			
Issue	**Risk**	**Opportunity**	**State Priority**
▪ Operations	*5a*) WCF could have difficulty in transitioning from a quasi-state agency to a stock company. Focus on profit sharpens from long-term to consistent quarterly results, which could limit WCF's ability to grow with profitability and provide quality, innovative service. Loss of tax exemption and focus on quarterly results could pressure increased premiums for their voluntary business.	*5b*) WCF would have to adjust their strategy to focus on consistent quarterly earnings. Their potential increased capital as a result of being a stock company could provide opportunity to make investments to grow and better serve their market through innovation. Ceding their most unprofitable business to the residual market could improve their results, more than offsetting the loss of the tax exemption. Thus, WCF's growth and profit potential could be significant along with their ability to provide quality service.	
▪ Federal Tax	*6a*) WCF losses tax exempt status. Investment portfolio may have to be restructured to reflect tax status.	*6b*) Competition in Utah market would increase as WCF would no longer have the tax exemption as a competitive pricing advantage.	
▪ Viability/Capital Requirements	*7a)* Subject to typical industry pressure. Potential pressure due to operations and loss of tax exemption.	*7b*) Viability could be enhanced by potential additional capital as a stock company. Best's A- rating would still be a "plus". Guaranty Fund status maintained. Diversification could increase spread of risk.	

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Alternative Organizational Structure #5

Demutualize into Independent Stock Insurance Company No Carrier of Last Resort (CLR), No Tax-Exemption

Stakeholder: 3. State			
Issue	**Risk**	**Opportunity**	**State Priority**
▪ Regulatory/ Implementation	*8a*) Legislation to confirm organizational status could be quite complex. Contemplates transition from quasi-state agency to a stock company, bypassing or including mutualization as an interim step. WCF would be subject to demutualization code. As a result of a new organizational structure, a Form A filing would be required for approval by the Utah Insurance Department.	*8b)* State clarifies and simplifies WCF regulatory status as subject to the Department of Insurance. Implementation options depend on how the demutualization is structured. Options include: 1. A phased demutualization over several years where only the policyholders become stockholders on day one, an IPO takes place at a later date 2. A full demutualization on day #1, including an IPO 3. A "partial" demutualization on day one where financial investors take an equity position, a full demutualization at a later date 4. Other variations	
▪ Economic Impact	*9a)* Limited positive to negative potential impact under the risks above. WCF could lose shareholder confidence and equity value. Management could move the headquarters out of Utah.	*9b*) Significant, positive, potential impact under the opportunities above. WCF could emerge as a significant regional or countrywide carrier with operations based in Salt Lake City.	
▪ Value	*10a*) Realizing State's value.	*10*b) Current value still a function of "control premium", "litigation risk premium", and "goodwill premium". Value could be greater than other options as a stock company. State could increase value transferred to policyholders, including to the State itself.	

Alternative Organizational Structure #6

Hybrid Structures: Restructure WCF Into Two Entities, a State Agency Carrier of Last Resort (CLR) and an Independent Stock Company

Stakeholder: 1. Policyholder

Issue	Risk	Opportunity	State Priority
▪ Availability/Residual Market	*1a)* State would have to implement a residual market alternative. A formally recognized "residual market" would exist as WCF non-renewed policyholders it would not write voluntarily. Availability may not be improved over other options	*1b)* WCF has historical knowledge and capacity to establish a tax exempt residual market CLR (as analyzed in alternative 2).	
▪ Affordability	*2b)* Having residual market stand on its own may necessitate premium increases due to poor experience and extra expense. The changes could also impact the voluntary market as the WCF responded to shareholder return expectations.	*2b*) Due to the experience of forming two separate legal entities, affordability may have limited upside. Voluntary market could benefit to some extent as previous residual market subsidiaries are diminished.	
▪ Quality Service	*3a*) WCF may have to allocate resources to staff the residual market carrier with uncertain impact on service.	*3b*) Residual market carrier would have to replicate WCF stock company services; again, with possible inefficiency.	
▪ Value	*4a*) Policyholders may concede some value to confirm ownership, and be subject to tax. Over time, value goes to remaining (non-residual market) policyholder. The timing may not be good to form a stock company.	*4b)* Policyholders confirm ownership and potential increased value over time. Valuation of WCF could likely be higher as a stock thus increasing policyholder value. Depending on the form of the demutualization transaction, the policyholders could get cash or become stockholders in WCF and have the potential for dividends and capital appreciation.	

Alternative Organizational Structure #6

Hybrid Structures: Restructure WCF Into Two Entities, a State Agency Carrier of Last Resort (CLR) and an Independent Stock Company

Stakeholder: 2. WCF

Issue	Risk	Opportunity	State Priority
▪ Operations	*5a)* WCF would be split to two companies with uncertain impact on the residual carriers ability to maintain operations. WCF could have difficulty in transitioning from a quasi-state agency to a stock company. Focus on profit sharpens from long-term to consistent quarterly results, which could limit WCF's ability to grow with profitability and provide quality, innovative service. Loss of tax exemption and focus on quarterly results could pressure increased premiums for their voluntary business.	*5b)* WCF may be more profitable as a result of no longer bearing residual market losses and increased pricing. WCF would have to adjust their strategy to focus on consistent quarterly earnings. Their potential increased capital as a result of being a stock company could provide opportunity to make investments to grow and better serve their market through innovation. Thus, WCF's growth and profit potential could be significant along with their ability to provide quality service.	
▪ Federal Tax	*6a)* Exemption lost to stock company. Investment portfolio may have to be restructured to reflect tax status.	*6b)* Exemption maintained for CLR.	
▪ Viability/Capital Requirements	*7a)* Uncertain for residual carrier. A capital contribution would be required to start operations. The stock carrier would be subject to typical industry pressure.	*7b)* For the stock company, viability could be enhanced by potential additional capital as a stock company. Best's A- rating would still be a "plus". Diversification could increase spread of risk.	

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Alternative Organizational Structure #6

Hybrid Structures: Restructure WCF Into Two Entities, a State Agency Carrier of Last Resort (CLR) and an Independent Stock Company

Stakeholder: 3. State			
Issue	**Risk**	**Opportunity**	**State Priority**
▪ Regulatory / Implementation	*8a*) Legislation could be quite complex. Implementation complex. Contemplates transition from quasi-state agency to a stock company, bypassing or including mutualization as an interim step. WCF would be subject to demutualization code. As a result of a new organizational structure, a Form A filing would be required for approval by the Utah Insurance Department.	*8b)* State clarifies and simplifies WCF regulatory status as subject to the DOI. Implementation options depend on how the demutualization is structured. Options include: 1. A phased demutualization over several years where only the policyholders become stockholders on day one, an IPO takes place at a later date. 2. A full demutualization on day #1, including an IPO. 3. A "partial" demutualization on day one where financial investors take an equity position, a full demutualization at a later date. 4. Other variations	
▪ Economic Impact	*9a)* Limited positive to negative potential impact under the risks above. WCF could lose shareholder confidence and equity value. Management could move the headquarters out of Utah.	*9b*) Significant, positive, potential impact under the opportunities above. WCF could emerge as a significant regional or countrywide carrier with operations based in Salt Lake City.	
▪ Value	*10a*) Realizing State's value.	*10b*) Current value still a function of "control premium", "litigation risk premium", and "goodwill premium". Value could be greater than other options as a stock company. State could increase value transferred to policyholders, including the State itself.	

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VII. Federal Tax Implications

Value of Federal Income Tax Exemption

The ability to maintain an exemption from Federal income tax could add significant value to any legal interest in the WCF. The magnitude of the value of the Federal tax exemption is dependent on the long-term profits of the WCF tax-exempt business[1] and the timing of when annual profits or losses would otherwise have been subject to Federal income tax. The timing of recognizing profits is relevant due to the annual accounting mechanism used to compute Federal income tax. In many cases companies can loose the time value of money on tax payments or the entire tax benefit of tax net operating losses due to the annual accounting mechanism or limitations on utilizing tax operating losses.[2]

It is important to note that any legal interest in the WCF's surplus that was generated in tax-exempt years should not be adversely affected by the alternative organizational structures. These amounts were earned while WCF qualified as a tax-exempt entity and should not be subject to Federal income taxes.[3]

Simply stated, any legal interest in the WCF, as a policyholder or otherwise, will benefit if the WCF maintains its tax exempt status under a new organizational structure.

WCF Qualification for Tax Exempt Status

Without specifics regarding the alternative organizational structures, our discussion cannot address the value to an interested party of WCF's Federal income tax exemption. We will focus instead on a high level discussion of how those organizational structures could impact WCF's

[1] This discussion focuses solely on the tax-exempt business of the WCF. The income of the WCF's taxable subsidiaries or Unrelated Business Income would not be impacted by a change in the organizational structure.
[2] Internal Revenue Code Sections 172 and 382 may limit the value of Net Operation Losses.
[3] It is assumed for purposes of this discussion that any transfer of value in the alternative organizational structures will be at fair market value.

tax-exempt status under the specific provisions of Internal Revenue Code Section ("IRC") 501(c)(27)(B).

The aforementioned tax benefits accruing to a legal interest in the WCF are not easily categorized or quantified. This difficulty results primarily from the public policy purpose behind the tax exemption provided by Congress to certain state-sponsored providers of workers compensation insurance.

To find support for the general rational behind Federal tax exemptions enacted for public policy reasons, one must look back to the committee reports accompanying the Revenue Act of 1938 which stated:

> "The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare."[4]

In the instant case the underlying Federal public policy goal is to subsidize a State's ability to form organizations that could help ensure employers in a given State have access to affordable worker's compensation insurance.

There is scant legislative history, regulations, or case law under IRC 501(c)(27)(B). However it is clear from what does exist, that the statute was meant, given the various changes in the form of state sponsored worker's compensation organizations, to be a clarification of Congressional intent with respect to the standards for tax exemption. This is evidenced by a discussion with the Chairman of the Senate Finance Committee, Senator Breaux stated:

> "Section 761 of the bill [later section 963] provides standards that a State-sponsored workers compensation company must meet in order to be exempt from Federal income tax for future years. As the chairman is aware, a large number of the States, including Louisiana, have State-sponsored workers compensation companies that have been operating as tax-exempt agencies for several years. It is my understanding that the standards that we have proposed for the future are intended to codify the standards that exist under present law and that a company, such as the one established by the State of Louisiana,

[4] H. Rep. No. 1860, 75th Congress, 3rd Session at 19 (1939).

> that met these standards in prior years should be confident that it is, in fact, tax exempt under current law. Is my understanding correct?"

Senator Roth replied:

> "The Senator is correct. The committee thought it was appropriate to provide prospective application for the codification of standards which must be met for tax exemption. However, the committee expressly acknowledged the fact that a number of States had established entities that were operating as tax exempt organizations. The motivation for codifying the standards as part of the Internal **[*7]** Revenue Code was to help these entities and the Internal Revenue Service more easily apply the law. However, our report expressly states that tax exemption may be available to many such State-sponsored entities under present law and no inference was intended to be drawn from our action that the income of those entities was not already tax-exempt."[5]

The requirements for exemption under IRC 501(c)(27)(B) are made relatively clear by a plain reading of the statute which reads:

(B) Any organization (including a mutual insurance company) if—

(i) such organization is created by State law and is organized and operated under State law exclusively to—

(I) provide workmen's compensation insurance which is required by State law or with respect to which State law provides significant disincentives if such insurance is not purchased by an employer, and

(II) provide related coverage which is incidental to workmen's compensation insurance

(ii) such organization must provide workmen's compensation insurance to any employer in the State (for employees in the State or temporarily assigned out-of-State) which seeks such insurance and meets other reasonable requirements related thereto,

(iii) (I) the state makes a financial commitment with respect to such organization either by extending the full faith and credit of the

[5] 143 Cong. Rec. S6703 (June 27, 1997).

State to the initial debt of such organization or by providing the initial operating capital of such organization, and

(II) in the case of periods after the date of enactment of this subparagraph, the assets of such organization revert to the State upon dissolution or State law does not permit the dissolution of such organization, and

(iv) the majority of the board of directors or oversight body of such organization are appointed by the chief executive officer or other executive brand official of the State, by the State legislature, or by both.

Therefore, as long as the WCF complies with the language and public policy goals of IRC 501(c)(27)(B), it will maintain its tax exempt status under the alternative organizational structures.

Impact of Organizational Structure on Tax Exempt Status

Again, without specifics, we cannot conclude on Federal income tax exemption for any of the organizational structures. However, the following are our high level thoughts on the potential consequences of the alternatives under IRC 501(c)(27)(B).

There are six organizational structures being contemplated in this study; maintaining the status quo, conversion to a stock company owned by the current insureds, sale to a non-policyholder, reverting the WCF to an agency of the State, and conversion to a "pure" mutual insurance company both with and without the company providing residual market coverage.

We understand the WCF currently complies with IRC 501(c)(27)(B) so we need not consider the status quo in this discussion.

Any organizational structure where the WCF does not, at a minimum, offer to provide coverage to any insured in the State would clearly be counter to both the public policy goals and a plain reading of the IRC 501(c)(27)(B). IRC 501(c)(27)(B)(ii) requires that the organization provide insurance to any employer in the State that meets "other reasonable requirements". One reading of this section would be that the "other reasonable requirements" is the equivalent of underwriting standards. Under this reading an organizational structure where WCF does not provide coverage to the residual market could qualify for the Federal tax exemption. However, we must question whether this reading would be consistent with the public policy goals of IRC 501(c)(27)(B). An argument could certainly be made that Congress was contemplating the residual market risk remaining with other more profitable risk for the organization to qualify as tax exempt. Bifurcating these coverages into two organizations may maximize the value of the tax exemption but would result in the Federal tax benefits accruing only to policyholders that are not in the residual market. Did Congress intend this outcome? Given this issue, we believe the alternative of converting the WCF to a pure mutual insurance company that does not provide residual market coverage could result in the WCF losing its tax-exempt status.

The same tax benefit issues apply to a sale of an interest in the WCF to a non-policyholder. We doubt from a reading of IRC 501(c)(27)(B) and our understanding of the underlying pubic policy goals that Congress intended that the tax benefits of the exemption accrue to anyone other than the State or the policyholders. The public policy goal of subsidizing workers compensation insurance and the Statutory requirements that the State initiate the fund, have a financial interest, and have some control over the net assets of the entity, either on formation or liquidation, seem to support the contention that the tax benefits were not meant to accrue to anyone other than the State of the policyholders. Therefore, a sale of an interest to a non-policyholder could also result in the WCF losing it tax-exempt status.

As previously discussed IRC 501(c)(27)(B) was enacted in response to the changing forms of state run workers compensation organizations. We can see no reason why simply changing the form of the organization to either a pure mutual that provides coverage to the residual market or a stock company owned by the policyholders would jeopardize the tax-exempt status of the WCF. Equally, converting the WCF to an agency of the State theoretically takes away the need to rely on IRC 501(c)(27)(B) and could provide a more liberal set of rules for tax exemption.

Therefore, it also seems unlikely the WCF would loose its tax-exempt status if converted to an agency of the State.

If the WCF moves forward with implementing any of the alternative organizational structures, we strongly recommend that the State obtain a Federal income tax ruling under the relevant tax authorities.

VIII. Impact on Policyholders

This section discusses the impact on rates and market dislocation of the different organizational structures on various policyholder groups. These comments are high-level observations, and precise quantification is not possible at this time based on the currently available information and limited project time.

Adoption of a Mutual or a Stock Insurance Company

The next few paragraphs apply to the alternative organizational structures which no longer have a Federal tax exemption. Therefore, the organization is not the carrier of last resort, and a residual market reinsurance pool has been created.

There is much debate and discussion as to whether mutual companies have a pricing advantage over stock companies. In our discussion, we assume that the pricing implications between a stock and mutual company are not significant, but do exist. A stock company will have to achieve returns for its shareholders that may be higher than those required for a mutual. A stock company will generally have to be more efficient than a mutual company to be equally competitive in pricing and may use a slightly different investment strategy. On the other hand, if a stock company would require higher prices, WCF policyholders could realize value in a stock company through ownership of the stock or sale of such stock to other parties.

Small Accounts

The implications of WCF's organizational strategy on small risks (small market) is uncertain. However, based on input from the NCCI and on knowledge of residual market pricing mechanisms, a reasonable expectation is that prices will increase for smaller risks if the WCF were not the CLR for the following reasons:

- The NCCI rating plan will apply to the residual market risks. WCF minimum premiums for small risks are low in comparison to those used by the NCCI rating plan which would apply if the NCCI administered the Plan. For example, WCF's current minimum premium is $400 and the NCCI minimum premium could range from $250 to $750 depending on the classification. Therefore, the WCF might non-renew many of its small policyholders, which might then be placed in the residual market. The NCCI estimates that for WCF 2002 policies in Utah, about 12,000 of 29,000 policies have premium less than $1000, and a little over a half of those pay less than $400. (The NCCI is not certain how association policies with lower average premiums affect these numbers, but it would appear that a large percentage of policyholders in Utah pay a small premium, which in a large percentage of the cases is the minimum premium.)

- If WCF is not the CLR, then it will lose its tax exemption. Therefore, many risks that WCF would have written at acceptable levels of profitability with the tax exemption may be non-renewed. Also, the NCCI will attempt to estimate the losses and the loss cost multiplier (LCM) for the residual market based on experience obtained from WCF, if possible, and benchmark experience from other states' residual markets. We believe that since the residual market rates will be established to be self-supporting, the new residual market rates will be greater than the existing rates, which may be currently subsidized by other segments of the WCF book of business.

When the Nevada State Fund (EICN) became a mutual insurer in 1999, there was also concern about the number of minimum-premium policies which might be transferred to the residual market. The actual number transferred was much less than expected even though ECIN non-renewed 18,000 policies. The actual number transferred was in the hundreds rather than the thousands because other insurers provided insurance to many of the policies that ECIN had non-renewed. However, the dynamics of the workers compensation market were more favorable to policyholders at that time. Insurers were in a competitive (soft) market and trying to gain market share. The market countrywide including Utah has generally hardened from what it was in the '90s. Therefore, insurers may not be as willing in the current environment to provide insurance if WCF were to non-renew several policies.

Mid-Market

The NCCI estimates that about half of Utah's 29,000 policyholders pay between $1,000 and $10,000 premium (mid market). Relative to smaller risks we expect that this group would be less affected by organizational strategy than small policyholders for the following reasons:

- Risks of this size may have some operations outside of Utah, and therefore would be less impacted by a change in premium, up or down.

- A probable upward premium effect may result from the loss of WCF's tax exemption. WCF may have to increase premium rates to achieve the same return as it had achieved historically. However, even though the profit provision would have to be increased, the profit provision is a relatively small portion of a premium dollar. Therefore, the impact on the base premium would be relatively small. Also, WCF would probably change its investment mix to a greater percentage of tax free investments, which would tend to reduce the impact of the loss of the tax exemption.

- Although premium increases may not be significant overall for mid-market accounts, certain industries may be considered "high" risk (e.g., contractors) by WCF and, therefore, may not be renewed by WCF. These industries will then need to seek insurance from the residual market plan. As such, there may be upward pressures on their rates similar to small accounts.

Larger accounts

For policyholders who pay more that $10,000 (large market) the impact of a change in organizational strategy would be even less than on the mid-market. The NCCI estimates about 3,400 policies in Utah. These risks would have more operations out of state to mitigate the impact of a change in Utah. The WCF's loss of the tax exemption would be the same or less than on the mid market because large risks are more "self-rated" than the smaller markets, meaning that they are rated based more on their own loss experience than the smaller markets.

For the State itself as a policyholder, the impact is more uncertain. If legislation is retained that requires the State to purchase its workers compensation insurance from the WCF, then the impact on the State is somewhat like that of other large market policyholders, except that it wouldn't have operations out of state to mitigate some of the impact. If the State is not required to purchase workers compensation insurance fom the WCF, the State might choose to self insure, in which case it would have premium dollars available for investment that it had previously paid to the WCF. Also, the State might save some premium expense dollars, even if it outsourced its claims handling to the WCF. The effect of being able to self insure could reduce the State's expenses, but it would retain the risk.

Status Quo

Under status quo, the structure of WCF remains as a quasi-governmental agency and WCF remains the carrier of last resort. As discussed above, there are statutes in other states that substantially limit, or prohibit, the provision of workers compensation coverage and services by an entity owned and controlled by another state. Because of the relationships between WCF and the State of Utah described above, some states are challenging the State of Utah's ownership and control of WCF. Therefore, under status quo, WCF stands to lose its out-of-state licenses (e.g., Idaho) or not be granted any additional out-of-state licenses (e.g., California). As a result, WCF may lose some of its multi-state accounts, and it will have a limited voluntary market to spread the residual market risks.

Small and Mid-market Accounts

The implication for small and mid-market accounts is the same: higher premium rates. WCF believes the multi-state accounts have been profitable accounts over time. As such, they shared in the burden for the residual market. If WCF loses its licenses in other states, then it may lose a portion, if not all, of the multi-state accounts. On a go-forward basis, there will be a smaller number of accounts over which to spread the residual market burden, and the remaining accounts will have to pay more premiums to cover the burden. In addition, with the loss of some out-of-state business, there will be a reduction in the geographic distribution of risks and reinsurance costs may increase. The increase in reinsurance costs will be directly borne by the remaining accounts.

Lastly, if WCF's profitability suffers as a result of the lost business, then there is a potential that the quality of service may falter. WCF may reduce expenses to combat the reduced profitability, and expense reductions could affect the service areas.

Large Accounts

We believe that large accounts may be affected in one of two ways. First, if WCF loses its out-of-state licenses, multi-state employers will be forced to make a decision regarding whether to keep its insurance with WCF or move it. Because WCF will no longer be licensed in all of the states in which the employer does business, WCF cannot write the insurance on the entire account. These multi-state accounts have two options. They can choose to renew their insurance for their Utah operations with WCF and purchase insurance for non-Utah business from another insurance carrier. The insurance administration for these employers becomes burdensome. The second option for multi-state accounts is not to renew their insurance with WCF and instead purchase it from another carrier who is licensed to do business in all of the states in which the employer does business. For these employers, we cannot estimate whether premium rates will decrease, remain the same, or increased. But there is definitely a real potential for these rates to increase.

Second, the large accounts with only Utah operations may continue to purchase insurance from WCF. If so, their premium rates will, most likely, increase for the same reasons discussed above: There will be a smaller number of accounts over which to spread the residual market burden, and the remaining accounts will have to pay more premium to cover the burden.

Mutual Company, Retaining the Insurer of Last Resort Status

If the State decides to privatize WCF as a mutual insurer and WCF retains the carrier of last resort status, then we do not believe that the policyholders will be impacted very much. Because WCF will become independent from the State, it will retain its out-of-state licenses. We expect that most of the multi-state accounts will stay with WCF, and the premium volume and geographic diversification will remain the same. Therefore, we expect premium rates to be roughly the same. The premium rates may increase due to the increase in medical costs and wage inflation. We would expect that rates would go up under any scenario for these reasons, but the relative amounts of the increases may vary by scenario.

As WCF expands into other states (although growth may be limited due to Federal tax exemption), WCF may increase its premium volume, thereby spreading the residual market burden over a greater number of accounts. In addition, with the greater diversification of risks, reinsurance costs may decrease. Therefore, if the geographic expansion is profitable, then the premium rates may actually decrease in the future.

Appendix A

Current List of State Funds

State	Fund Name	Type of Fund
Arizona	State Comp Fund	Competitive
California	State Comp Insurance Fund	Competitive
Colorado	Pinnacol Assurance	Competitive
Hawaii	Employers' Mutual Ins. Co.	Competitive
Idaho	State Insurance Fund	Competitive
Kentucky	Employers' Mutual Ins. Co.	Competitive
Louisiana	Workers' Comp. Corporation	Competitive
Maine	Employers' Mutual Ins. Co.	Competitive
Maryland	Injured Workers' Insurance Fund	Competitive
Minnesota	State Fund Mutual Ins. Co.	Competitive
Missouri	Employers' Mutual Ins. Co.	Competitive
Montana	State Fund	Competitive
Nevada	Employers Insurance Company	Monopolistic
New Mexico	Mutual Casualty Company	Competitive
New York	State Insurance Fund	Competitive
North Dakota	Workers' Compensation	Monopolistic
Ohio	Bureau of Workers' Comp.	Monopolistic
Oklahoma	State Insurance Fund	Competitive
Oregon	SAIF Corporation	Competitive
Pennsylvania	State Workers' Insurance Fund	Competitive
Rhode Island	Beacon Mutual Insurance Co.	Competitive
South Carolina	State Accident Fund	Competitive
Texas	Workers' Comp. Ins. Fund	Competitive
Utah	Workers' Compensation Fund	Competitive
Washington	Dept. of Labor and Industries	Monopolistic
West Virginia	Workers' Compensation Division	Monopolistic
Wyoming	Division of Workers Safety	Monopolistic

Appendix B

MODEL ASSUMPTIONS

Dynamic Financial Analysis (DFA) is a means of analyzing an insurance company's financial position through future time horizons under several potential conditions. Our analysis of surplus uses a simplified DFA approach (or surplus model) to help us determine the variability and reasonableness of WCF's statutory surplus and to provide output and diagnostics on excess statutory surplus This appendix describes the assumptions used within the surplus model.

Assumptions

Restatement of Statutory Surplus

Our model restates WCF's statutory reserves (surplus) so that the reserves correspond to the mid-point of the actuary's reserve range. In addition, the reserves are also adjusted to include the benefit of tabular discounts. The actuary's mid-point and the tabular reserves decrease statutory reserves and increases statutory surplus by $30.3 million.

Risk Free Rate of Return

The risk free rate of return is a stochastic variable used to model interest rates. The interest rate generator is an autoregressive model which projects a future interest rate based on the current interest rate and a long-term average interest rate. The interest rate process used in our model is based on the work of Cox, Ingersoll and Ross. The model has both a deterministic element and a stochastic element. The model takes the following form:

$$cr = a(b - r) + s(\sqrt{r})\,Z$$

where:

cr = the change in interest level

a = a constant that represents the speed of adjustment in interest rates

b = the long term mean interest rate level

r = the current interest rate level

s = annual volatility of the interest rates

Z = random number from the standard normal distribution

The assumptions used in our model are determined by reviewing the annual treasury yields over the past thirty years with average maturity of five years. The assumptions used are below:

a = .2339

b = 8.0%

r = 4.0%

s = 0.0854

General Inflation

The general inflation rate in our model is correlated with the simulated annual interest rate. We performed a least squares regression analysis of general inflation rates and the annual interest rates. The parameters of the regression analysis were as follows:

$$g = a + br + sZ$$

where:

g = the simulated general inflation rate

a = 0.2% = y-intercept of the regression analysis

b = 60.0% = slope of the regression analysis

r = the simulated risk free interest rate

s = 1.0% = the standard error of the residuals (errors)

Z = random number from the standard normal distribution

Once a given year's risk-free interest rate is generated, the general inflation rate is simulated by plugging the simulated interest rate into the formula above. The annual general inflation rate is used to calculate both the indemnity trend and also the trend in loss adjustment expenses.

Investment Return

The investment return for a given year is also correlated with the simulated annual interest rate. A least-squares regression analysis is also used to estimate the investment return except that WCF's annual return on invested assets was regressed on the annual interest rate. The parameters of the regression analysis were as follows:

$$i = a + br + sZ$$

where:

i = the simulated investment return

a = 4.0% = y-intercept of the regression analysis

b = 50.0% = slope of the regression analysis

r = the simulated risk free interest rate

s = 4.0% = the standard error of the residuals (errors)

Z = random number from the standard normal distribution

The simulated investment returns are used to calculate investment gain net of expenses in a given year. Investment gain represents a return on invested assets which includes investment income earned, realized capital gains, and unrealized capital gains.

Medical Inflation

We took a slightly different approach to estimate medical inflation. Rather than projecting medical inflation using a least squares regression approach on the risk-free rate, we model the gap between medical inflation and general inflation. Previously, we mentioned that there is an expectation that the gap between medical and general inflation, although currently large, will become small in the future. Therefore, our model assumes an expected gap of 9% in 2002 and reduces annually down to 2%. We assume that the gap is normally distributed around its mean or expected gap with a standard deviation set so that the simulated gap will be within plus or minus 2.0% of the expected gap 95% of the time. The medical inflation factor is used to estimate the reserve and ultimate cost of medical losses.

Indemnity Trend

We estimate indemnity trend from the general inflation trend. Our model assumes an expected gap of –2.0% from general inflation. The expected gap is a deterministic assumption and therefore does not vary. However, the indemnity trend does vary from year to year since general inflation varies. We also include annual caps on the indemnity trend. The minimum indemnity trend is 3% and the maximum indemnity trend is 5%. The indemnity trend factor is used to estimate the reserve and ultimate cost of indemnity losses.

Loss and Loss Adjustment Expenses

We rely heavily upon the assumptions used in the actuarial analysis and our review of that actuarial analysis.

Payment patterns are derived implicitly through the incremental paid method. For both indemnity losses and medical-on-indemnity losses, initial incremental severities are selected from our loss reserve analysis and they are trended forward using the simulated indemnity and medical trend factors. Reserves and paid losses at the end of each year are estimated based on these payment patterns.

Medical-only losses are estimated by first selecting a 2002 accident year severity. Future accident year severities are trended forward using the simulated future medical inflation factors. Reserves and calendar years payments are calculated using payment patterns from our loss reserve analysis.

Each reserve estimate above relies upon an estimate of the ultimate number of total claims. We assume that the ultimate number of claims is normally distributed with a standard deviation of 1,000 indemnity claims. We have assumed that “real exposure” and frequency trend will be flat into the future.

Tabular Discounts

As of December 31, 2001, tabular discounts were 17.6% of the indemnity reserves. We have assumed that this percentage will continue into the future.

Underwriting Expense Ratio

Underwriting expenses incurred are estimated using a 27.3% underwriting expense ratio to written premium.

Catastrophic Risk

The potential for catastrophes has also been modeled in our analysis. WCF may have some risk to catastrophe such as earthquakes, terrorist attacks, etc. We have included a 1-in-35 year chance of a major catastrophe that would total to as much as 20% of premium.

Appendix C

Pro-Forma Exhibits - Discounted Cash Flow Model
Scenario 1 – Independent Stock Company

Workers Compensation Fund

Exhibit 1

VALUATION AS OF DECEMBER 31, 2003

Dollars in Thousands

Cost of Capital Assumption	12.0%

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Terminal Value
Cash (or Surplus) Flow	71,122	53,362	33,921	(18,858)	(41,001)	(946)	40,796	64,999	42,331	25,565	344,584
Discount Factor @ 12%	1.000	0.893	0.797	0.712	0.636	0.567	0.507	0.452	0.404	0.361	0.361
Present Value @ 12/02	71,122	47,644	27,041	(13,423)	(26,057)	(537)	20,669	29,402	17,097	9,219	124,260

ESTIMATED VALUE	**306,438**

Workers Compensation Fund

Exhibit 2

DIVIDENDS AND CAPITAL PAID IN

Dollars in Thousands

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Surplus-to-RBC Company Action Level	2.71	2.59	2.40	1.82	1.70	1.99	2.26	2.43	2.27	2.15
Constraint	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Required Surplus	201,216	179,821	171,465	210,858	277,720	314,284	316,166	301,211	313,509	344,584
Year-End Surplus prior to Dividend	272,338	233,182	205,386	192,000	236,719	313,338	356,962	366,210	355,839	370,148
Maximum Allowable Dividend	71,122	53,362	33,921	(18,858)	(41,001)	(946)	40,796	64,999	42,331	25,565
Actual Dividend	71,122	53,362	33,921	-	-	-	40,796	64,999	42,331	25,565
Actual Capital Contribution Required	-	-	-	18,858	41,001	946	-	-	-	-
Ending Statutory Surplus	201,216	179,821	171,465	210,858	277,720	314,284	316,166	301,211	313,509	344,584

Deloitte & Touche

Workers Compensation Fund

PERFORMANCE METRICS

Dollars in Thousands

Exhibit 3

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Statutory Surplus	249,826	201,216	179,821	171,465	210,858	277,720	314,284	316,166	301,211	313,509	344,584
Gross Written Premium	198,865	215,476	228,288	273,190	325,814	399,042	475,480	512,787	553,312	597,351	645,227
Net Written Premium	189,394	212,244	224,864	269,092	320,926	393,056	468,348	505,095	545,013	588,390	635,548
Loss + LAE Reserve	518,949	563,204	596,538	650,626	721,070	811,375	919,449	1,029,751	1,143,168	1,262,964	1,391,181
Gross Written Premium-to-Surplus	79.60%	107.09%	126.95%	159.33%	154.52%	143.68%	151.29%	162.19%	183.70%	190.54%	187.25%
Net Written Premium-to-Surplus	75.81%	105.48%	125.05%	156.94%	152.20%	141.53%	149.02%	159.76%	180.94%	187.68%	184.44%
Reserves-to-Surplus	207.72%	279.90%	331.74%	379.45%	341.97%	292.16%	292.55%	325.70%	379.52%	402.85%	403.73%
Total Net Leverage	283.54%	385.38%	456.79%	536.39%	494.17%	433.69%	441.57%	485.46%	560.46%	590.53%	588.17%
Net Earned Premium	180,446	213,009	219,724	261,862	312,606	381,581	456,373	499,014	538,422	581,246	627,799
Incurred Loss + LAE	137,507	170,467	157,018	181,835	211,109	247,065	284,733	310,274	334,087	359,814	387,678
Underwriting Expense	51,680	53,262	63,681	78,955	97,226	122,981	149,859	162,224	175,693	190,371	206,373
Policyholder Dividend	2,442	2,750	0	0	0	0	0	0	0	0	0
Net Investment Income	42,827	39,006	35,957	35,507	36,530	40,383	47,542	54,200	59,165	63,441	69,107
Yield on Invested Assets	5.34%	4.90%	4.54%	4.39%	4.27%	4.14%	4.15%	4.16%	4.16%	4.15%	4.15%
Loss + LAE Ratio	76.20%	80.03%	71.46%	69.44%	67.53%	64.75%	62.39%	62.18%	62.05%	61.90%	61.75%
Underwriting Expense Ratio	27.29%	25.09%	28.32%	29.34%	30.30%	31.29%	32.00%	32.12%	32.24%	32.35%	32.47%
Policyholder Dividend Ratio	1.35%	1.29%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Combined Ratio	104.84%	106.41%	99.78%	98.78%	97.83%	96.04%	94.39%	94.29%	94.29%	94.26%	94.22%
Investment Income-to-NEP	23.73%	18.31%	16.36%	13.56%	11.69%	10.58%	10.42%	10.86%	10.99%	10.91%	11.01%
Operating Ratio	81.11%	88.10%	83.42%	85.22%	86.14%	85.45%	83.97%	83.43%	83.30%	83.34%	83.22%
% Change in Statutory Surplus	1.84%	-19.46%	-10.63%	-4.65%	22.97%	31.71%	13.17%	0.60%	-4.73%	4.08%	9.91%
Effective Tax Rate	0.0%	0.0%	0.0%	46.5%	48.5%	48.6%	46.6%	44.8%	44.3%	44.4%	44.3%

Deloitte & Touche

Workers Compensation Fund

Exhibit 4

STATUTORY BALANCE SHEET

Dollars in Thousands

ASSETS	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Bonds	626,226	622,230	636,470	674,146	769,390	905,791	1,032,640	1,127,235	1,208,701	1,316,648	1,448,976
Stocks	110,331	109,483	111,496	117,098	132,032	152,685	171,943	186,598	202,942	224,345	246,880
Other Invested Assets	60,001	59,618	60,982	64,592	73,718	86,787	98,941	108,004	115,810	126,153	138,831
Total Cash & Invested Assets	796,558	791,331	808,948	855,836	975,140	1,145,264	1,303,523	1,421,838	1,527,453	1,667,146	1,834,687
Agent, Premium Balances	9,490	10,635	11,268	13,484	16,081	19,696	23,469	25,310	27,310	29,484	31,847
Statutory Deferred Tax Asset	0	0	0	7,948	9,098	10,896	12,674	14,094	15,137	16,440	17,860
Other Assets	20,456	20,891	21,278	21,917	22,734	23,795	25,037	26,206	27,413	28,690	30,060
TOTAL ASSETS	826,504	822,858	841,494	899,185	1,023,052	1,199,650	1,364,703	1,487,448	1,597,313	1,741,760	1,914,454
LIABILITIES	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Loss and LAE Reserves	518,949	563,204	596,538	650,626	721,070	811,375	919,449	1,029,751	1,143,168	1,262,964	1,391,181
Unearned Premium Reserve	37,312	36,546	41,687	48,917	57,237	68,712	80,687	86,768	93,358	100,503	108,252
Unpaid Expense	13,838	14,262	17,051	21,141	26,033	32,929	40,126	43,437	47,044	50,974	55,259
Dividends Declared and Unpaid	1,004	1,619	0	0	0	0	0	0	0	0	0
Borrowed Money	0	0	0	0	0	0	0	0	0	0	0
Other Liabilities	5,576	6,011	6,398	7,036	7,853	8,914	10,157	11,325	12,532	13,810	15,179
TOTAL LIABILITES	576,679	621,642	661,674	727,720	812,194	921,930	1,050,419	1,171,282	1,296,102	1,428,251	1,569,871
POLICYHOLDER SURPLUS	**249,826**	**201,216**	**179,821**	**171,465**	**210,858**	**277,720**	**314,284**	**316,166**	**301,211**	**313,509**	**344,584**

Workers Compensation Fund

Exhibit 5

STATUTORY INCOME STATEMENT

Dollars in Thousands

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
UNDERWRITING INCOME											
Earned Premium	180,446	213,009	219,724	261,862	312,606	381,581	456,373	499,014	538,422	581,246	627,799
Incurred Loss+LAE	137,507	170,467	157,018	181,835	211,109	247,065	284,733	310,274	334,087	359,814	387,678
Incurred Other U/W Expense	51,680	53,262	63,681	78,955	97,226	122,981	149,859	162,224	175,693	190,371	206,373
Write-Ins for Underwriting Deductions	0										
Net Underwriting Gain or Loss	(8,742)	(10,720)	(975)	1,073	4,270	11,536	21,780	26,516	28,643	31,060	33,749
INVESTMENT INCOME											
Net Investment Income Earned	42,827	39,006	35,957	35,507	36,530	40,383	47,542	54,200	59,165	63,441	69,107
Net Realized Capital Gain or Loss	(25,896)	0	0	0	0	0	0	0	0	0	0
Net Investment Gain or Loss	16,931	39,006	35,957	35,507	36,530	40,383	47,542	54,200	59,165	63,441	69,107
OTHER INCOME											
Net Gain or Loss from Agents' Balances/Premiums	(2,356)	(2,781)	(2,869)	(3,419)	(4,081)	(4,982)	(5,958)	(6,515)	(7,029)	(7,588)	(8,196)
Finance & Service Charges Not in Premiums	0	0	0	0	0	0	0	0	0	0	0
Write-in for Miscellaneous Income	68	0	0	0	0	0	0	0	0	0	0
Total Other Income	(2,288)	(2,781)	(2,869)	(3,419)	(4,081)	(4,982)	(5,958)	(6,515)	(7,029)	(7,588)	(8,196)
NET INCOME											
Net income before federal tax & policyholder dividends	5,902	25,505	32,113	33,161	36,719	46,937	63,364	74,202	80,779	86,913	94,660
Policyholder dividends	2,442	2,750	0	0	0	0	0	0	0	0	0
Interest Expense on Borrowed Money	0	0	0	0	0	0	0	0	0	0	0
Net income before federal income tax	3,460	22,755	32,113	33,161	36,719	46,937	63,364	74,202	80,779	86,913	94,660
Federal & foreign income tax incurred	0	0	0	15,430	17,818	22,835	29,537	33,249	35,762	38,614	41,900
Net Income	**3,460**	**22,755**	**32,113**	**17,731**	**18,901**	**24,102**	**33,827**	**40,953**	**45,017**	**48,299**	**52,760**
CAPITAL AND SURPLUS ACCOUNT											
Surplus as of 12/31 of Prior Year	245,307	249,826	201,216	179,821	171,465	210,858	277,720	314,284	316,166	301,211	313,509
Net Income	3,460	22,755	32,113	17,731	18,901	24,102	33,827	40,953	45,017	48,299	52,760
Net Unrealized Capital Gain or Loss	(2,498)	(242)	(147)	(114)	485	(40)	13	305	3,985	5,026	2,460
Dividends to Stockholders	0	(71,122)	(53,362)	(33,921)	0	0	0	(40,796)	(64,999)	(42,331)	(25,565)
Capital Paid In	0	0	0	0	18,858	41,001	946	0	0	0	0
Change in Deferred Tax Asset	0	0	0	7,948	1,149	1,798	1,778	1,420	1,043	1,303	1,420
Other Changes in Capital and Surplus	3,557	0	0	0	0	0	0	0	0	0	0
Change in Surplus	4,519	(48,609)	(21,395)	(8,356)	39,393	66,862	36,564	1,882	(14,954)	12,297	31,075
Surplus as of 12/31 of Current Year	249,826	201,216	179,821	171,465	210,858	277,720	314,284	316,166	301,211	313,509	344,584

Advantage Workers Compensation Insurance Company

Exhibit 6

STATUTORY BALANCE SHEET

Dollars in Thousands

ASSETS	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Bonds	10,754	10,035	10,813	11,620	12,588	13,862	15,200	16,006	19,367	23,549	25,878
Stocks	0	0	0	0	0	0	0	0	0	0	0
Other Invested Assets	3,756	3,505	3,776	4,058	4,396	4,841	5,309	5,590	6,764	8,225	9,038
Total Cash & Invested Assets	14,510	13,540	14,589	15,678	16,984	18,703	20,509	21,596	26,130	31,774	34,916
Agent, Premium Balances	378	477	1,029	1,614	2,359	3,436	4,562	5,019	5,520	6,072	6,680
Statutory Deferred Tax Asset	196	75	161	253	369	538	715	786	865	951	1,046
Other Assets	133	(267)	7	326	725	1,296	1,913	2,207	2,479	2,765	3,077
TOTAL ASSETS	15,217	13,825	15,787	17,871	20,437	23,974	27,698	29,607	34,994	41,563	45,719
LIABILITIES	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Loss and LAE Reserves	0	0	0	0	0	0	0	0	0	0	0
Unearned Premium Reserve	1,008	1,067	2,303	3,611	5,277	7,688	10,208	11,228	12,351	13,586	14,945
Unpaid Expense	1,434	(0)	0	0	0	0	(0)	0	0	0	0
Dividends Declared and Unpaid	0	0	0	0	0	0	0	0	0	0	0
Borrowed Money	0	0	0	0	0	0	0	0	0	0	0
Other Liabilities	607	265	573	898	1,313	1,912	2,539	2,793	3,072	3,379	3,717
TOTAL LIABILITES	3,048	1,333	2,876	4,509	6,590	9,601	12,747	14,021	15,423	16,966	18,662
POLICYHOLDER SURPLUS	**12,169**	**12,492**	**12,911**	**13,362**	**13,847**	**14,373**	**14,952**	**15,586**	**19,571**	**24,597**	**27,057**
Statutory Unamortized Goodwill	**3,158**	**2,593**	**2,027**	**1,461**	**1,461**	**896**	**330**	**0**	**0**	**0**	**0**
Value Carried to WCF	**15,327**	**15,085**	**14,938**	**14,824**	**15,309**	**15,269**	**15,282**	**15,586**	**19,571**	**24,597**	**27,057**

Advantage Workers Compensation Insurance Company

Exhibit 7

STATUTORY INCOME STATEMENT

Dollars in Thousands

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
UNDERWRITING INCOME											
Earned Premium	4,891	7,000	14,000	22,576	33,242	48,447	65,003	73,253	80,579	88,637	97,500
Incurred Loss+LAE	4,891	7,000	14,000	22,576	33,242	48,447	65,003	73,253	80,579	88,637	97,500
Incurred Other U/W Expense	(231)	(0)	0	0	0	0	(0)	0	0	0	0
Write-Ins for Underwriting Deductions	0										
Net Underwriting Gain or Loss	231	0	(0)	(0)	0	(0)	0	0	(0)	(0)	0
INVESTMENT INCOME											
Net Investment Income Earned	707	573	534	576	619	670	738	809	852	1,031	1,254
Net Realized Capital Gain or Loss	0	0	0	0	0	0	0	0	0	0	0
Net Investment Gain or Loss	707	573	534	576	619	670	738	809	852	1,031	1,254
OTHER INCOME											
Net Gain or Loss from Agents' Balances/Premiums	0	0	0	0	0	0	0	0	0	0	0
Finance & Service Charges Not in Premiums	0	0	0	0	0	0	0	0	0	0	0
Write-in for Miscellaneous Income	0	0	0	0	0	0	0	0	0	0	0
Total Other Income	0	0	0	0	0	0	0	0	0	0	0
NET INCOME											
Net income before federal tax & policyholder dividends	938	573	534	576	619	670	738	809	852	1,031	1,254
Policyholder dividends	0	0	0	0	0	0	0	0	0	0	0
Interest Expense on Borrowed Money	0	0	0	0	0	0	0	0	0	0	0
Net income before federal income tax	938	573	534	576	619	670	738	809	852	1,031	1,254
Federal & foreign income tax incurred	238	128	202	216	250	313	336	246	263	309	366
Net Income	**700**	**445**	**332**	**360**	**368**	**357**	**402**	**563**	**590**	**722**	**888**
CAPITAL AND SURPLUS ACCOUNT											
Surplus as of 12/31 of Prior Year	11,262	12,169	12,492	12,911	13,362	13,847	14,373	14,952	15,586	19,571	24,597
Net Income	700	445	332	360	368	357	402	563	590	722	888
Net Unrealized Capital Gain or Loss	0	0	0	0	0	0	0	0	0	0	0
Dividends to Stockholders	0	0	0	0	0	0	0	0	0	0	0
Capital Paid In	0	0	0	0	0	0	0	0	3,317	4,217	1,477
Change in Deferred Tax Asset	196	(122)	87	92	117	169	176	71	79	86	95
Other Changes in Capital and Surplus	11	0	0	0	0	0	0	0	0	0	0
Change in Surplus	907	323	419	451	485	525	579	635	3,985	5,026	2,460
Surplus as of 12/31 of Current Year	12,169	12,492	12,911	13,362	13,847	14,373	14,952	15,586	19,571	24,597	27,057

Deloitte & Touche

Appendix D

Pro-Forma Exhibits - Discounted Cash Flow Model
Scenario 2 – Independent Mutual Company (No Restrictions)

Workers Compensation Fund

Exhibit 1

VALUATION AS OF DECEMBER 31, 2003
Dollars in Thousands

Cost of Capital Assumption	12.0%

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Terminal Value
Free Cash Flow	71,056	68,784	32,808	9,557	7,143	9,122	11,478	13,471	15,116	16,657	230,279
Discount Factor @ 12%	1.000	0.893	0.797	0.712	0.636	0.567	0.507	0.452	0.404	0.361	0.361
Present Value @ 12/02	71,056	61,415	26,154	6,803	4,540	5,176	5,815	6,094	6,105	6,007	83,041

ESTIMATED VALUE	282,204

Workers Compensation Fund

Exhibit 2

DIVIDENDS AND CAPITAL PAID IN
Dollars in Thousands

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Surplus-to-RBC Company Action Level	2.92	2.71	2.84	2.42	2.12	2.08	2.10	2.12	2.13	2.14	2.14
Constraint	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Required Surplus	171,383	201,216	164,329	155,850	164,219	175,280	186,313	197,204	208,056	219,023	230,279
Year-End Surplus prior to Dividend	249,826	272,272	233,114	188,658	173,776	182,423	195,435	208,682	221,527	234,139	246,935
Maximum Allowable Dividend (Capital Required)	78,442	71,056	68,784	32,808	9,557	7,143	9,122	11,478	13,471	15,116	16,657
Actual Dividend	-	**71,056**	**68,784**	**32,808**	**9,557**	**7,143**	**9,122**	**11,478**	**13,471**	**15,116**	**16,657**
Actual Capital Contribution Required	-	-	-	-	-	-	-	-	-	-	-
Ending Statutory Surplus	249,826	201,216	164,329	155,850	164,219	175,280	186,313	197,204	208,056	219,023	230,279

Workers Compensation Fund

Exhibit 3

PERFORMANCE METRICS

Dollars in Thousands

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Statutory Surplus	249,826	201,216	164,329	155,850	164,219	175,280	186,313	197,204	208,056	219,023	230,279
Gross Written Premium	198,865	215,476	212,353	229,963	247,834	266,144	277,168	287,204	297,627	308,454	319,700
Net Written Premium	189,394	212,244	209,168	226,514	244,116	262,152	273,011	282,896	293,163	303,827	314,904
Loss + LAE Reserve	518,949	563,204	587,810	623,421	664,149	708,943	753,735	798,285	842,718	887,668	933,894
Gross Written Premium-to-Surplus	79.60%	107.09%	129.22%	147.55%	150.92%	151.84%	148.76%	145.64%	143.05%	140.83%	138.83%
Net Written Premium-to-Surplus	75.81%	105.48%	127.29%	145.34%	148.65%	149.56%	146.53%	143.45%	140.91%	138.72%	136.75%
Reserves-to-Surplus	207.72%	279.90%	357.70%	400.01%	404.43%	404.46%	404.55%	404.80%	405.04%	405.29%	405.55%
Total Net Leverage	283.54%	385.38%	484.99%	545.35%	553.08%	554.02%	551.09%	548.26%	545.95%	544.01%	542.30%
Net Earned Premium	180,446	213,009	206,311	223,511	241,113	259,168	271,080	281,122	291,322	301,917	312,922
Incurred Loss + LAE	137,507	170,467	147,428	158,495	169,975	181,476	189,411	196,272	203,241	210,454	217,916
Underwriting Expense	51,680	53,262	57,562	63,079	68,760	74,853	78,150	81,079	84,125	87,293	90,588
Policyholder Dividend	2,442	2,816	2,542	2,649	2,758	2,839	2,928	3,019	3,111	3,206	3,304
Net Investment Income	42,827	39,006	35,959	34,350	34,403	35,508	37,988	40,415	42,795	45,169	47,566
Yield on Invested Assets	5.34%	4.90%	4.54%	4.39%	4.26%	4.13%	4.14%	4.14%	4.14%	4.15%	4.15%
Loss + LAE Ratio	76.20%	80.03%	71.46%	70.91%	70.50%	70.02%	69.87%	69.82%	69.77%	69.71%	69.64%
Underwriting Expense Ratio	27.29%	25.09%	27.52%	27.85%	28.17%	28.55%	28.63%	28.66%	28.70%	28.73%	28.77%
Policyholder Dividend Ratio	1.35%	1.32%	1.23%	1.19%	1.14%	1.10%	1.08%	1.07%	1.07%	1.06%	1.06%
Combined Ratio	104.84%	106.44%	100.21%	99.94%	99.81%	99.67%	99.58%	99.55%	99.53%	99.50%	99.46%
Investment Income-to-NEP	23.73%	18.31%	17.43%	15.37%	14.27%	13.70%	14.01%	14.38%	14.69%	14.96%	15.20%
Operating Ratio	81.11%	88.13%	82.78%	84.58%	85.54%	85.97%	85.56%	85.18%	84.84%	84.54%	84.26%
% Change in Statutory Surplus	1.84%	-19.46%	-18.33%	-5.16%	5.37%	6.74%	6.29%	5.85%	5.50%	5.27%	5.14%
Effective Tax Rate	0.0%	0.0%	0.0%	43.3%	44.8%	45.4%	43.8%	43.0%	41.6%	41.1%	40.3%

Deloitte & Touche

Workers Compensation Fund

Exhibit 4

STATUTORY BALANCE SHEET

Dollars in Thousands

ASSETS	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Bonds	626,226	622,262	615,742	634,884	676,505	723,759	769,995	815,345	860,571	906,248	953,193
Stocks	110,331	109,487	108,352	111,130	117,903	124,986	131,937	139,007	146,407	153,894	161,593
Other Invested Assets	60,001	59,621	58,996	60,830	64,818	69,346	73,776	78,121	82,454	86,831	91,329
Total Cash & Invested Assets	796,558	791,370	783,090	806,845	859,227	918,091	975,708	1,032,473	1,089,432	1,146,972	1,206,115
Agent, Premium Balances	9,490	10,635	10,481	11,350	12,233	13,136	13,680	14,176	14,690	15,225	15,780
Statutory Deferred Tax Asset	0	0	0	7,050	7,471	8,222	8,752	9,543	10,066	10,723	11,428
Other Assets	20,456	20,892	21,169	21,561	22,004	22,487	22,952	23,413	23,873	24,339	24,819
TOTAL ASSETS	826,504	822,897	814,741	846,807	900,934	961,936	1,021,092	1,079,605	1,138,061	1,197,259	1,258,142
LIABILITIES	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Loss and LAE Reserves	518,949	563,204	587,810	623,421	664,149	708,943	753,735	798,285	842,718	887,668	933,894
Unearned Premium Reserve	37,312	36,546	39,402	42,405	45,408	48,392	50,323	52,097	53,938	55,848	57,830
Unpaid Expense	13,838	14,262	15,413	16,890	18,411	20,043	20,925	21,710	22,525	23,374	24,256
Dividends Declared and Unpaid	1,004	1,658	1,497	1,560	1,624	1,672	1,724	1,777	1,832	1,888	1,945
Borrowed Money	0	0	0	0	0	0	0	0	0	0	0
Other Liabilities	5,576	6,011	6,289	6,681	7,123	7,606	8,072	8,532	8,992	9,459	9,938
TOTAL LIABILITES	576,679	621,681	650,411	690,957	736,715	786,656	834,779	882,401	930,005	978,236	1,027,864
POLICYHOLDER SURPLUS	**249,826**	**201,216**	**164,329**	**155,850**	**164,219**	**175,280**	**186,313**	**197,204**	**208,056**	**219,023**	**230,279**

Workers Compensation Fund

Exhibit 5

STATUTORY INCOME STATEMENT

Dollars in Thousands

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
UNDERWRITING INCOME											
Earned Premium	180,446	213,009	206,311	223,511	241,113	259,168	271,080	281,122	291,322	301,917	312,922
Incurred Loss+LAE	137,507	170,467	147,428	158,495	169,975	181,476	189,411	196,272	203,241	210,454	217,916
Incurred Other U/W Expense	51,680	53,262	57,562	63,079	68,760	74,853	78,150	81,079	84,125	87,293	90,588
Write-Ins for Underwriting Deductions	0										
Net Underwriting Gain or Loss	(8,742)	(10,720)	1,321	1,937	2,378	2,839	3,519	3,771	3,956	4,170	4,417
INVESTMENT INCOME											
Net Investment Income Earned	42,827	39,006	35,959	34,350	34,403	35,508	37,988	40,415	42,795	45,169	47,566
Net Realized Capital Gain or Loss	(25,896)	0	0	0	0	0	0	0	0	0	0
Net Investment Gain or Loss	16,931	39,006	35,959	34,350	34,403	35,508	37,988	40,415	42,795	45,169	47,566
OTHER INCOME											
Net Gain or Loss from Agents' Balances/Premiums	(2,356)	(2,781)	(2,693)	(2,918)	(3,148)	(3,383)	(3,539)	(3,670)	(3,803)	(3,942)	(4,085)
Finance & Service Charges Not in Premiums	0	0	0	0	0	0	0	0	0	0	0
Write-in for Miscellaneous Income	68	0	0	0	0	0	0	0	0	0	0
Total Other Income	(2,288)	(2,781)	(2,693)	(2,918)	(3,148)	(3,383)	(3,539)	(3,670)	(3,803)	(3,942)	(4,085)
NET INCOME											
Net income before federal tax & policyholder dividends	5,902	25,505	34,587	33,370	33,633	34,963	37,968	40,516	42,948	45,397	47,898
Policyholder dividends	2,442	2,816	2,542	2,649	2,758	2,839	2,928	3,019	3,111	3,206	3,304
Interest Expense on Borrowed Money	0	0	0	0	0	0	0	0	0	0	0
Net income before federal income tax	3,460	22,689	32,044	30,720	30,875	32,124	35,040	37,497	39,837	42,192	44,595
Federal & foreign income tax incurred	0	0	0	13,316	13,829	14,584	15,352	16,110	16,575	17,324	17,965
Net Income	**3,460**	**22,689**	**32,044**	**17,404**	**17,046**	**17,540**	**19,688**	**21,387**	**23,263**	**24,868**	**26,630**
CAPITAL AND SURPLUS ACCOUNT											
Surplus as of 12/31 of Prior Year	245,307	249,826	201,216	164,329	155,850	164,219	175,280	186,313	197,204	208,056	219,023
Net Income	3,460	22,689	32,044	17,404	17,046	17,540	19,688	21,387	23,263	24,868	26,630
Net Unrealized Capital Gain or Loss	(2,498)	(242)	(147)	(126)	459	(86)	(64)	190	538	558	577
Dividends to Stockholders	0	(71,056)	(68,784)	(32,808)	(9,557)	(7,143)	(9,122)	(11,478)	(13,471)	(15,116)	(16,657)
Capital Paid In	0	0	0	0	0	0	0	0	0	0	0
Change in Deferred Tax Asset	0	0	0	7,050	421	751	530	791	523	657	706
Other Changes in Capital and Surplus	3,557	0	0	0	0	0	0	0	0	0	0
Change in Surplus	4,519	(48,609)	(36,887)	(8,479)	8,369	11,061	11,033	10,891	10,852	10,967	11,256
Surplus as of 12/31 of Current Year	249,826	201,216	164,329	155,850	164,219	175,280	186,313	197,204	208,056	219,023	230,279

Advantage Workers Compensation Insurance Company

Exhibit 6

STATUTORY BALANCE SHEET

Dollars in Thousands

ASSETS	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Bonds	10,754	10,035	10,541	10,996	11,486	12,025	12,457	12,898	13,357	13,832	14,325
Stocks	0	0	0	0	0	0	0	0	0	0	0
Other Invested Assets	3,756	3,505	3,682	3,841	4,012	4,200	4,351	4,505	4,665	4,831	5,003
Total Cash & Invested Assets	14,510	13,540	14,223	14,837	15,498	16,225	16,808	17,403	18,022	18,663	19,329
Agent, Premium Balances	378	477	711	874	1,058	1,282	1,364	1,432	1,504	1,579	1,658
Statutory Deferred Tax Asset	196	75	111	137	166	201	214	224	236	247	260
Other Assets	133	(267)	(147)	(54)	44	163	216	253	290	330	371
TOTAL ASSETS	15,217	13,825	14,898	15,794	16,765	17,871	18,602	19,313	20,051	20,819	21,617
LIABILITIES	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Loss and LAE Reserves	0	0	0	0	0	0	0	0	0	0	0
Unearned Premium Reserve	1,008	1,067	1,591	1,956	2,366	2,868	3,052	3,204	3,364	3,533	3,709
Unpaid Expense	1,434	(0)	0	0	0	0	0	0	0	0	0
Dividends Declared and Unpaid	0	0	0	0	0	0	0	0	0	0	0
Borrowed Money	0	0	0	0	0	0	0	0	0	0	0
Other Liabilities	607	265	396	487	589	713	759	797	837	879	923
TOTAL LIABILITES	3,048	1,333	1,987	2,443	2,955	3,581	3,811	4,001	4,201	4,411	4,632
POLICYHOLDER SURPLUS	**12,169**	**12,492**	**12,911**	**13,351**	**13,810**	**14,290**	**14,792**	**15,312**	**15,850**	**16,408**	**16,985**
Statutory Unamortized Goodwill	**3,158**	**2,593**	**2,027**	**1,461**	**1,461**	**896**	**330**	**0**	**0**	**0**	**0**
Value Carried to WCF	**15,327**	**15,085**	**14,938**	**14,812**	**15,271**	**15,185**	**15,121**	**15,312**	**15,850**	**16,408**	**16,985**

Advantage Workers Compensation Insurance Company

Exhibit 7

STATUTORY INCOME STATEMENT

Dollars in Thousands

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
UNDERWRITING INCOME											
Earned Premium	4,891	7,000	10,000	12,576	15,242	18,469	20,003	21,043	22,096	23,200	24,360
Incurred Loss+LAE	4,891	7,000	10,000	12,576	15,242	18,469	20,003	21,043	22,096	23,200	24,360
Incurred Other U/W Expense	(231)	(0)	0	0	0	0	0	0	0	0	0
Write-Ins for Underwriting Deductions	0										
Net Underwriting Gain or Loss	231	0	0	(0)	(0)	0	0	(0)	0	(0)	0
INVESTMENT INCOME											
Net Investment Income Earned	707	573	534	561	585	611	640	663	687	711	736
Net Realized Capital Gain or Loss	0	0	0	0	0	0	0	0	0	0	0
Net Investment Gain or Loss	707	573	534	561	585	611	640	663	687	711	736
OTHER INCOME											
Net Gain or Loss from Agents' Balances/Premiums	0	0	0	0	0	0	0	0	0	0	0
Finance & Service Charges Not in Premiums	0	0	0	0	0	0	0	0	0	0	0
Write-in for Miscellaneous Income	0	0	0	0	0	0	0	0	0	0	0
Total Other Income	0	0	0	0	0	0	0	0	0	0	0
NET INCOME											
Net income before federal tax & policyholder dividends	938	573	534	561	585	611	640	663	687	711	736
Policyholder dividends	0	0	0	0	0	0	0	0	0	0	0
Interest Expense on Borrowed Money	0	0	0	0	0	0	0	0	0	0	0
Net income before federal income tax	938	573	534	561	585	611	640	663	687	711	736
Federal & foreign income tax incurred	238	128	152	147	155	167	151	154	159	165	171
Net Income	**700**	**445**	**382**	**414**	**430**	**444**	**489**	**509**	**527**	**546**	**565**
CAPITAL AND SURPLUS ACCOUNT											
Surplus as of 12/31 of Prior Year	11,262	12,169	12,492	12,911	13,351	13,810	14,290	14,792	15,312	15,850	16,408
Net Income	700	445	382	414	430	444	489	509	527	546	565
Net Unrealized Capital Gain or Loss	0	0	0	0	0	0	0	0	0	0	0
Dividends to Stockholders	0	0	0	0	0	0	0	0	0	0	0
Capital Paid In	0	0	0	0	0	0	0	0	0	0	0
Change in Deferred Tax Asset	196	(122)	37	26	29	35	13	11	11	12	12
Other Changes in Capital and Surplus	11	0	0	0	0	0	0	0	0	0	0
Change in Surplus	907	323	419	440	459	479	502	520	538	558	577
Surplus as of 12/31 of Current Year	12,169	12,492	12,911	13,351	13,810	14,290	14,792	15,312	15,850	16,408	16,985